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Washington, D.C. 20554

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In the Matter of	)	
	)	
Access Charge Reform	)	CC Docket No. 96-262
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No 94-1
	)	
Transport Rate Structure and Pricing	)	CC Docket No. 91-213
	)	
Usage of the Public Switched Network by Information Service and Internet Access Providers	)	CC Docket No. 96-263

REPLY COMMENTS OF THE AD HOC TELECOMMUNICATIONS USERS COMMITTEE

Economic Consultants:

Susan M. Gately
Helen E. Golding
Economics and Technology, Inc.
One Washington Mall
Boston, MA 02108-2617
617-227-0900

James S. Blaszak
Kevin DiLallo
Levine, Blaszak, Block & Boothby
1300 Connecticut Avenue, N.W.
Suite 500
Washington, D.C. 20036-1703
202-223-4980

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SUMMARY

The Ad Hoc Committee is in good company in urging the Commission to eliminate the CCLC and raise the SLC caps for residential lines beyond the primary line and for multi-line businesses. A wide range of commenters – including state regulators and incumbent local exchange carriers ("ILECs") – agree with this position. In addition, a considerable group of commenters supports the Commission's proposal to allow ILECs to impose a per-line charge on each interexchange carrier ("IXC") based on its number of presubscribed lines and on subscribers who have not presubscribed an IXC.

The Ad Hoc Committee has determined that revenues presently generated by the SLC are more than sufficient to recover the interstate portion of loop costs if carriers are allowed to recover only total service long-run incremental costs ("TSLRIC").

The Ad Hoc Committee has also been joined by a loud chorus of support for reinitializing price cap rate levels based on default rates for unbundled network elements ("UNEs"), a reasonable surrogate for TSLRIC – the appropriate measure of costs that ILECs should be permitted to recover on a going-forward basis. Any more fundamental overhaul of the price caps regime is unwarranted, however. USTA's and PacTel's efforts to reduce or eliminate the X-Factor should not be considered here, but the Commission should immediately initiate another comment round to resolve longstanding open issues concerning the appropriate level for the X-Factor.

Basing the costs which the ILECs can recover on TSLRIC would not run afoul of the fifth amendment's proscription of governmental takings of private property without just compensation. As a matter of law, regulated utilities are not entitled to simultaneous protection from financial risk and unregulated earning potential. The Ad Hoc Committee has proposed an alternative that would allow ILECs to choose which of these objectives is more important, thereby depriving the ILECs of the opportunity to argue that their failure to recover embedded investment is an unlawful taking.

The Ad Hoc Committee continues to believe that the Commission should neither permit nor require the price cap LECs to impose call set-up charges and that it is premature to create new rate elements for SS7 signaling.

TABLE OF CONTENTS

Page

I. There Is Widespread Agreement Among Divergent Interest Groups that LECs Should Recover The Interstate Portion of Loop Costs Through Increased SLCs and, if Necessary, a Flat-Rated Per-Line Charge on IXCs and End Users Without PICs 4

II. The FCC Should Not Subvert the Extensive X-Factor Record That Has Been Developed in the *Price Cap* Fourth FNRPM Before It Issues a Decision in that Docket 7

III. The Commission Should Not Forbear from Regulating any Interstate Service In the Absence of Public, Auditable Information and an Affirmative Showing that Effective Competition Exists Throughout the Relevant Product and Geographic Markets for the Service 15

IV. The ILECs Should Not Be Given New Opportunities for Earnings Growth Unless they Shoulder a Symmetric Risk of Loss in the Value of Certain Tangible Assets 19

V. The Ad Hoc Committee's "Make-Whole-or-Make-Money" Solution Would Address ILEC Concerns That the Prescriptive Approach Would Result in "Confiscation" 22

CONCLUSION 25

Attachment A: "Establishing the X-Factor for the FCC Long-Term LEC Price Cap Plan."

Attachment B: "Reply to X-Factor Proposals for the FCC Long-Term LEC Price Cap Plan."

Attachment C: February 3, 1997 Press Release: "Local Phone Companies Show Interconnection Agreements in Virtually Every State."

Attachment D: "Review of TELRIC Loop Costs and Overall SLC Revenue Levels."

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REPLY COMMENTS OF THE AD HOC TELECOMMUNICATIONS USERS COMMITTEE

The Ad Hoc Telecommunications Users Committee (the "Ad Hoc Committee") submits these Reply Comments in response to the Notice of Proposed Rulemaking ("NPRM") in the referenced proceeding[1] and the comments that have been submitted thereon. A wide range of commenters – including state regulators and incumbent local exchange carriers ("ILECs") – support recovering the interstate portion of non-traffic-sensitive ("NTS") loop costs entirely through the subscriber line charge ("SLC"), and, if the SLC is insufficient to recover all of those costs, allowing the ILECs to impose a per-line

[1] Notice of Proposed Rulemaking, Third Report and Order, and Notice of Inquiry, FCC 96-488 (released December 24, 1996).

charge on each interexchange carrier ("IXC") based on its number of presubscribed lines and on subscribers who have not presubscribed an IXC. Most commenters support elimination of the present usage-sensitive carrier common line charge ("CCLC"). Revenues presently generated by the SLC are more than sufficient to recover the interstate portion of loop costs if the costs carriers are allowed to recover are limited to total service long-run incremental costs ("TSLRIC").

In addition, there is broad support for reinitializing price cap rate levels based on default rates for unbundled network elements ("UNEs"), which provide a reasonable surrogate for TSLRIC – the appropriate measure of costs that ILECs should be permitted to recover on a going-forward basis. However, a more fundamental overhaul of the price caps regime would be unwarranted based on the information submitted, and would be unwise from a procedural perspective. Although certain ILEC parties, notably USTA and PacTel have proposed in their initial comments that the X-Factor be decreased or eliminated, their arguments are inadequately supported, based on unreliable data, and in any event, inappropriate for consideration in this proceeding. Given the potential impact of their proposals, and the lack of a meaningful opportunity for other parties to analyze and critique them, the Commission should defer consideration of those proposals to a later comment round when all parties would have the opportunity to examine the proposals and underlying support with a critical eye and to fully respond to them. There are too many other crucial issues at stake in this proceeding to attempt to give adjustment of the X-Factor the consideration it deserves. However, the Ad Hoc Committee urges the Commission to act expeditiously with respect to possible adjustment of the X-Factor, and to initiate another comment round as soon as possible to allow full consideration of the USTA and PacTel proposals and other parties' critiques of those proposals.

Certain commenters representing ILEC interests have argued that they can not be denied the ability to recover their embedded investments without running afoul of the fifth amendment's proscription of governmental takings of private property without just compensation.[2] Although the Ad Hoc Committee disagrees with that position, it has proposed – and the Commission has sought comment on – a solution to such concerns. The solution would give each ILEC the option of choosing between a *make whole* approach to regulation (in which it would be assured of recovering its embedded investment but its earnings would be regulated) or a *make money* approach to regulation (in which its earnings would be unregulated, but its embedded investment would be treated like that of any competitive firm, with no assurance of recovery). By giving each carrier this choice, a carrier could not claim that the *government* had denied it the opportunity to recover its investment.

Finally, some commenters, particularly certain financial services providers who are large users of telecommunications services, echoed the Ad Hoc Committee's views that the Commission should neither permit nor require the price cap LECs to impose call set-up charges and that it is premature to create

[2] Comments of Bell Atlantic and NYNEX at 16-17; Comments of BellSouth at 56; and Comments of Pacific Telesis ("PacTel") at 44-45.

new rate elements for SS7 signaling.[3] The Ad Hoc Committee concurs with those commenters' Reply Comments being filed today, to the extent they address call set-up charges and the creation of new SS7 signaling rate elements.

I. There Is Widespread Agreement Among Divergent Interest Groups that LECs Should Recover The Interstate Portion of Loop Costs Through Increased SLCs and, if Necessary, a Flat-Rated Per-Line Charge on IXCs and End Users Without PICs.

In its initial comments, the Ad Hoc Committee showed that the recovery of NTS loop costs on a usage-sensitive basis was economically inefficient, and thus, that the ILECs should recover their interstate loop costs through the subscriber line charge.[4] The Committee endorsed the Commission's proposal that the CCLC be eliminated and that the SLC could be increased if necessary to allow the ILECs to recover the complete interstate costs of the loop. At a minimum, the Committee endorsed the Commission's proposal to raise or eliminate the cap on the SLC for non-primary residential lines and multi-line businesses to the level of the per-line loop costs assigned to the interstate jurisdiction.[5]

These measures should be insufficient to allow the ILECs to recover all of their interstate loop costs, but, if not, then the Ad Hoc Committee advocated the

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[3] *See, generally,* Comments of MasterCard International Incorporated, VISA USA, Inc., The New York Clearing House Association, and Bankers Clearing House (filed January 29, 1997) ("Financial Service Providers' Comments").

[4] Comments of the Ad Hoc Telecommunications Users Committee (filed January 29, 1997) ("Ad Hoc Comments") at 6-12.

[5] Ad Hoc Comments at 10.

approach recommended by the Commission, whereby unrecovered interstate loop costs would be recovered through a flat a per-line charge on each interexchange carrier ("IXC") based on its number of presubscribed lines and on subscribers who have not presubscribed an IXC.

The Ad Hoc Committee views in this regard are shared by many of the commenters. Most notably, several of the parties representing state regulators and even ILECs have endorsed the same method of interstate loop cost recovery that Ad Hoc endorses. For example, in endorsing the recovery of residual loop costs through a charge on IXCs and end users not preselecting an IXC, USWest argued that

> [a]ll users of the local loop should be required to contribute to the recovery of costs which have been allocated to the interstate jurisdiction. US WEST prefers this approach to bulk billing because it is easier to administer and it relates the charge directly to the loop, which gives rise to the costs the charge is intended to defray.[[6]]

Similarly, USTA wrote that it "supports the Joint Board's recommendation that incumbent LECs recovered the CCL costs through a flat-rate, per-line charge paid by interexchange carriers. As the Commission pointed out, assessing the charge against each customer's presubscribed interexchange carrier (PIC), or directly to any end user who elects not to cho[o]se a PIC, facilitates administrative simplicity."[7]

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6 Comments of US West, Inc. (filed January 29, 1997) ("US West Comments") at 54.

7 USTA Comments at 55-56.

And while state regulators traditionally have disfavored shifting recovery of interstate loop costs from the CCLC to the SLC, the State of California and the California Public Utilities Commission wrote that they

> recommend that the FCC eliminate the carrier common line charge (CCLC), as California did with its intrastate CCLC in 1994, and order recovery of CCLC revenue for both single and multi-line business customers, and for non-primary residential lines, by raising the subscriber line charge (SLC). To recover CCLC revenue currently earned from primary residential lines, the CPUC suggests use of a per line charge paid by interexchange carriers (IXCs).[8]

Generally speaking, other interest groups, particularly the interexchange carriers, cable interests and competitive local exchange carriers, generally favored the same approach to recovering the interstate portion of loop costs. The Commission can not and should not discount the overwhelming support for this economically sensible method of cost recovery.

This is particularly true because it appears that the present SLC revenues more than recover what would be the interstate portion of forward-looking loop costs, based on the TSLRIC loop costs identified by the Commission in its Order in CC Docket 96-98,[9] and the overall level of SLC revenues collected today.[10] Table 1 of Attachment D demonstrates that the annual TELRIC-Default Interstate NTS assignment for loops would be in the range of $6.18 billion, while

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8 Comments of the People of California and the California Public Utilities Commission (filed January 29, 1997) at 1-2.

9 *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996,* CC Dkt. No. 96-98, First Report and Order (rel. August 8, 1996).

10 See Attachment D hereto. *Accord,* MCI Comments (filed January 29, 1997) at 70.

present annual SLC revenues (based on the same loop counts) would be approximately $7.05 billion. That being the case, a decision by the Commission to allow ILECs to recover only forward-looking costs from access services would not, in the aggregate, necessitate an increase in SLC revenues.[11]

II. The FCC Should Not Subvert the Extensive X-Factor Record That Has Been Developed in the *Price Cap* Fourth FNRPM Before It Issues a Decision in that Docket.

In response to the Commission's request for comments on whether it should increase the existing X-factor as a method of reducing access charges,[12] USTA, Pacific Telesis, and perhaps others have attempted to divert attention *away* from the central focus of this proceeding by once again making their hackneyed claims that the X-Factor should be reduced. USTA proposes an "X" of 2.7 *minus* a .04 per year "access reform" correction, for a net value of approximately 2.3.[13] PacTel goes farther, suggesting elimination of the "X" altogether.[14]

The Commission should not allow any party to use this proceeding to undermine the extensive X-Factor record that has been developed in the *Price Cap* Fourth FNRPM.[15] As the NPRM acknowledges, many participants in that

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11 Although in the aggregate the existing SLC revenues are greater than the total forward-looking interstate loop assignment, that would not be the case in each jurisdiction. According to the Ad Hoc Committee's analysis, however, using the default costs identified in CC Docket No. 96-98, the existing SLC caps would allow full recovery of the interstate loop component in jurisdictions that account for some 82% of all access lines in the U.S.

12 NPRM at ¶ 233.

13 USTA Comments at 21.

14 PacTel Comments at 40-42.

15 *Price Cap Performance Review for Local Exchange Carriers,* CC Dkt. No. 94-1, Fourth Further Notice of Proposed Rulemaking, 10 FCC Rcd 13659 (1995) ("Price Cap Fourth FNPRM").

proceeding, including the Ad Hoc Committee, have urged the Commission expeditiously to complete that proceeding and adopt a higher X-Factor.[16] But this is not the proper forum to do so. While the level of price caps X-Factor will continue to play a crucial role in setting access rates, even after the extensive overhaul of the access charge regime contemplated by the NPRM, the focus of this proceeding is on access charge reform, not price caps *per se*. And while the Commission has requested comments on specific, *incremental* modifications to the price cap regime that would be compatible with the access reforms to be adopted here,[17] the correct context for considering more fundamental changes to the price caps regime, such as the level of the X-Factor, is in CC Docket 94-1, not here.[18]

In support of its argument that the X-Factor should be reduced, USTA has submitted a paper entitled "Updated Results for the Simplified TFPRP Model and Response to Productivity Questions in FCC's Access Reform Proceeding" (the

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16 NPRM at ¶ 233.

17 Examples of such modifications are the reinitialization of price cap rate levels to incremental costs and the reduction of the authorized rate of return to reflect current capital market conditions.

18 The ILECs' position that the X-Factor should be reduced (or eliminated altogether) as a result of access charge reform seems to be part and parcel of their theory that the Commission can not reform the access charge regime and open ILECs' markets to competition unless it "makes them whole" with respect to capital investments they claim to have made to build their networks. The fact is, however, that price caps was touted as "de-linking" prices from costs, to shift investment risks from ratepayers to shareholders, in exchange for increasing the potential rewards shareholders could realize in the form of earnings in beyond nominally authorized levels. And all the RBOCs have accomplished just that under the Commission's price cap regime: As Ad Hoc and others have shown in comments and studies submitted in response to the Fourth Further Notice of Proposed Rulemaking in CC Docket 94-1, the extraordinarily high earnings levels RBOCs have achieved indicate that an appropriate X-Factor would be as high as 8.5% to 11%. *See, e.g.,* Reply Comments of MCI in response to Fourth FNPRM, CC Docket No. 94-1 (filed March 1, 1996) at 9. It is nothing short of *chutzpah* that the RBOCs — who have collectively amassed billions of dollars in excess profits under price caps — should now attempt to use the price cap mechanism to shift risks and losses back to ratepayers and thereby recapture all the downside protections that the prior rate of return regulation (RORR) regime had provided, just when they may need it, given the threat of competition in their formerly closed markets.

"Updated Christensen Study").[19] As the title suggests, the authors of the study have attempted to update the so-called "Simplified" Total Factor Productivity ("TFP") study USTA submitted in response to the FCC's Fourth FNPRM in CC Docket 94-1, which itself was a departure from the original TFP study USTA submitted.[20] More specifically, the authors have updated the previous model to include results for 1995, many of which are *estimates* based upon average annual growth rates for the 1990 to 1994 period.[21]

The only other apparent "update" the authors have made to their earlier study is to incorporate new Bureau of Economic Analysis ("BEA") "chain-weighted" indexes for 1995.[22] USTA's motivation for submitting the updated study seems to be to have the last word on the X-Factor after its original and simplified studies were discredited by the Ad Hoc Committee and others in CC Docket 94-1.

In that proceeding, the Ad Hoc Committee submitted two studies by Economics and Technology, Inc. (ETI), to support the Committee's initial and reply comments on the Fourth FNPRM. The first ETI study, entitled *Establishing the X-Factor for the FCC Long-Term LEC Price Cap Plan* (attached to these Reply Comments as Attachment A), emphasized the importance of an input price adjustment and further refined the measurement of input price changes to reflect

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19 Laurits Christensen, Philip E. Schoech, and Mark E. Meitzen, "Updated Results for the Simplified TFPRP Model and Response to Productivity Questions in FCC's Access Reform Proceeding," Attachment 5 to USTA Comments (filed January 29, 1997).

20 Updated Christensen Study at 1.

21 *Id.* at 4-5.

22 *Id.* at 1. The BEA "fixed weight" index values for the years 1988 to 1994 are left intact by the authors.

measures of price movements publicly available from disinterested sources as well as hedonic adjustments to the nominal price changes to reflect the significant enhancements in capacities and capabilities of the various capital inputs that are not captured in nominal price series.

In addition, the initial ETI study emphasized the need to develop an interstate-only TFP measure, rather than one based upon total company operations. The study also highlighted a number of other methodological deficiencies in the Christensen/USTA study methodology. ETI's analysis demonstrated that, when the necessary corrections of the various deficiencies were made to the Christensen/USTA study, the correct X-Factor (including the input price differential and a modest 0.5% Consumer Productivity Dividend) is 9.9% for jurisdictionally interstate services.

ETI's second study, entitled *Reply to X-Factor Proposals for the FCC Long-Term LEC Price Cap Plan*, responded to simplified Christensen study which USTA sponsored. The ETI study (attached to these comments as Attachment B) demonstrated that, while the simplified Christensen study offered *some* improvement over the original Christensen study because it substituted publicly available data for proprietary LEC data, it was still deficient in many respects and it still suffered from many of the same fundamental errors that had been made in the original study. Specifically, like the original study, the simplified study:

- failed to consider productivity growth applicable to jurisdictionally *interstate* services, and instead provided only a total company TFP result;
- used a short-term post-divestiture input price data series in calculating LEC TFP, but a long-term pre- and post-divestiture

economy-wide input price series for calculating the input price differential, resulting in the erroneous conclusion that LEC input price growth is identical to economy-wide input price growth;

- failed to recognize or make hedonic adjustments to the measurement of the capital input to reflect changes in quality and/or capacity of inputs, resulting in an overstatement of LEC input price growth for the capital input vis-a-vis the US economy as a whole;

- used a cost of capital that failed to reflect the expected rate of return for the LECs;

- used a rental price formula that fails to reflect the debt/equity distinction under the US tax code;

- used depreciation rates that are inapplicable to LECs' telecommunications plant and that are based on a much earlier time period than the post-divestiture period of Christensen's study; and

- derived output quantities using a deflated revenue approach that relies upon seemingly flawed output price indices, instead of utilizing output measures based upon direct physical quantities.

The combined effect of these errors was a gross understatement of the productivity offset that is appropriate for LEC interstate telephone services: Christensen's simplified study produced an X-factor result of only 2.8%.[23] His updated study, submitted here, produces a slightly lower X-Factor of 2.7%.[24] By comparison, ETI's first study calculated a corrected X-Factor (including input price differential and consumer productivity dividend) for jurisdictionally interstate services of **9.9%**.[25]

In its second study, ETI overlaid corrections of the various deficiencies described above to the Christensen simplified study (for the years 1989 to 1994),

23 Christensen "Simplified" study, CC Docket 94-1, p. 32.

24 USTA Attachment 5, p. 2.

and showed that, when corrected, the X-Factor results for the simplified Christensen study showed are, as with the original Christensen study, *in the range of 8% to 9% for jurisdictionally interstate services.*

But the Commission need not rely only on the studies that have been submitted, because the RBOCs' actions speak far more loudly than their consultants' words. When offered the opportunity to choose among three alternative X-Factors -- *all of which were well above the laughable 2.7 Christensen number* described above -- six of the seven RBOCs voluntarily selected and have been operating under a 5.3% X-Factor,[26] the highest of the three X-Factor levels adopted in the Commission's *First Report and Order.* And even with a 5.3% X-Factor, those six RBOCs have consistently reported interstate earnings of between 13.3% and 17.3%![27]

Clearly, in purporting to craft a simplified model, USTA and its consultants have stripped it of any connection to reality. USTA's proposed 2.7% X-Factor does not even satisfy the "red face test," and it must be seen as a transparent attempt to stake out some ground to the south of the 4.0% to 5.3% interim X-Factor values and divert attention away from the RBOCs' consistent overearnings. Reality — not theory — confirms that the interim X-Factor values are woefully deficient and must be increased substantially to capture actual productivity and input price conditions confronting the RBOCs now and in the future, as opposed to

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25 ETI Report, *Establishing the X-Factor for the FCC Long-term LEC Price Cap Plan*, p. 55.

26 TELECOMMUNICATIONS REPORTS, May 15, 1995, at 4-5.

27 FCC Form 492A, Year-End 1995.

reflecting over-simplified theoretical claims based on *backward-looking* historic studies.

Incongruently, while it persists in citing Christensen's contrived "empirical evidence" to discredit Ad Hoc's and AT&T's demonstrations of a significant and persistent input price differential, USTA concurrently offers (but for a different purpose) an affidavit by USTA experts Rohlfs, Jackson, and Richardson of Strategic Policy Research, Inc. (SPR), highlighting the rapid decline in the prices of digital switches and other capital inputs that are being purchased by the ILECs,[28] as well as the significant increases in the capacities and capabilities of switches, fiber optic cables, and transmission systems (the hedonic effects addressed in the two ETI studies discussed above). USTA offers the Rohlfs/SPR Study to support its position that the economic value of ILEC assets has declined dramatically due to the rapidly falling prices of each technological vintage; but in the same filing, USTA offers Dr. Christensen's analysis, which flatly denies the existence of those very same extraordinary price decreases.[29]

One can only suspect that USTA assumes nobody will draw the connection between Christensen and Rohlfs/SPR, but connected they surely are. Indeed, the Christensen paper, in its denial of input price decreases relative to the economy-wide price level, discredits and impeaches the picture SPR has painted; conversely, SPR's unwavering description of the significant and persistent price

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[28] Jeffrey H. Rohlfs, Charles L. Jackson and Ross M. Richardson, Strategic Policy Research, "The Depreciation Shortfall," ("Rohlfs/SPR Study") Attachment 15 to USTA Comments at 13.

[29] *Compare* Updated Christensen Study, *supra*, note 17 *with* Rohlfs/SPR Study, *supra*, note 25.

decreases across all major ILEC capital inputs underscores the unreliability of Christensen's "empirical" conclusion.

Because of the serious errors that remain uncorrected in Christensen's simplified study, and the complex issues surrounding the calculation of a TFP-based X-Factor, it would be unreasonable and inappropriate for the Commission to adopt the TFP estimate USTA has presented in this proceeding without full consideration of the extensive record built in CC Docket 94-1. Incremental changes to the present price cap regime to accommodate the access charge reforms that may be adopted here — such as the reinitialization of price cap rate levels to incremental costs and the reduction of the authorized rate of return to reflect current capital market conditions — can and should be pursued. Wholesale overhaul of price caps regulation by slashing the X-Factor should not.

The submission of the Updated Christensen Study highlights the need for the Commission to act expeditiously in CC Docket No. 94-1 to resolve open issues concerning the appropriate level for the X-Factor. The Ad Hoc Committee urges the Commission to conclude that proceeding at the Commission's earliest opportunity.

III. The Commission Should Not Forbear from Regulating any Interstate Service In the Absence of Public, Auditable Information and an Affirmative Showing that Effective Competition Exists Throughout the Relevant Product and Geographic Markets for the Service.

In the NPRM, the Commission solicits comments on whether it should forbear from regulating high-capacity special access services immediately.[30]

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[30] *NPRM* at ¶ 153.

In its comments, USTA proposes that the Commission forbear from regulating *not only high-capacity, but all* special access services, on the ground that "direct substitutes for special access services exist and increasingly are being used by LEC customers."[31] USTA's request is overly broad and the data on which it relies is both anecdotal and undocumented. For example, USTA describes competition for high-capacity special access in certain large urban markets but asks for regulatory forbearance of *all* special access services in *all geographic areas*.[32]

The existence of isolated competition for a DS1 service is no indication that a competitive service or price level will be available to a customer who needs to purchase an analog special access line. And the existence of competition in large urban markets does not ensure or even suggest that price-constraining competition exists in smaller cities, towns, or rural locations.[33]

In fact, there is no evidence that USTA members treat analog special access and private line services as competitive. It is not uncommon, for example, for ILECs to quote four- to six-week installation times for voice-grade analog and 56kb or DS-0 digital circuits, or to impose non-recurring installation charges that are many multiples of those applicable to switched voice grade lines. While ILECs may claim that these services require case-by-case design and processing, they

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31 USTA Comments at 43.

32 Ad Hoc does not take issue with the assertion that there is strong competition for high capacity special access in many large urban markets. However, the Commission has already given LECs considerable pricing flexibility for high-cap services offered in these markets.

33 USTA's proposal exemplifies the need (discussed by Ad Hoc in its earlier Comments in this proceeding) to define properly the product and geographic markets the Commission will examine to ascertain the level of effective competition.

have never faced a sufficient level of competition to spur them to make the changes required to provision these services more efficiently and more expeditiously. *If anything*, regulatory oversight of the provisioning and pricing of analog and DS-0 special access services should be *increased* so that these important services do not become the victims of competition in other segments of the special access market.

There is another important reason why the Commission should refuse to grant USTA's request for forbearance: Lack of reliable data. To support its request, USTA runs through a litany of undocumented instances where ILECs allegedly lost high capacity special access market share to competitors in various major urban markets.[34] Only one of the market share figures USTA has provided in its comments is supported by a citation, and even there, the referenced study has not been produced, thus preventing examination by other parties.[35] All of the other "statistics" are simply asserted, without any indication of their sources. This data cannot begin to be considered as "quantification" responsive to the questions in the NPRM.

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[34] USTA Comments at 43-44. In a press release issued on February 3, 1997, USTA refers to market share losses in "high capacity *local business service*." This vague and (apparently) misleading characterization led one prominent trade publication to report incorrectly that "USTA figures show that incumbent LECs have lost 39% of their *market share* in Philadelphia, 35% in Pittsburgh" and so forth, implying that the market share losses were sustained in the *overall* local market, rather than in the specialized, high capacity special access service market. (emphasis added). See Attachment C. Although the implausibility of such a statement should be immediately evident to any informed person that attempts to purchase local exchange and exchange access services from an alternative supplier, it exemplifies the danger inherent in accepting market share numbers that are offered without supporting documentation.

[35] USTA Comments at 43-44. The same numbers are repeated, also without any reference to their sources, in the affidavit filed by Schmalensee and Taylor at p. 37, and attached to USTA's Comments as Attachment 1.

The Commission and interested parties need an opportunity to examine critically the factual and methodological basis for the market share data referenced by USTA. Because the need to quantify and assess claims of competition in various product and geographic markets will only increase over time, the Commission should not establish a pattern by allowing USTA and the ILECs to base requests for forbearance on incomplete and undocumented claims.

Another problem with USTA's request for forbearance – in this case, for direct trunked transport – is that it has a warped view of what constitutes "close substitutes for services [that will] foster market forces that will generally ensure that rates, practices, and classifications of interexchange carriers are just and reasonable."[36] USTA contends that once a competitor has collocated at an ILEC central office, the Commission should conclude that direct trunked transport substitutes exist.[37] As with USTA's proposal for special access forbearance, there are both substantive and procedural problems with USTA's recommendation concerning direct trunked transport.

Contrary to USTA's contention, simply because a competitor has collocated in a central office does not mean that the competitor is presently supplying sufficient alternative capacity to create an effective competitive alternative to LEC direct trunked transport service for itself and other competitors. Moreover, it is vital as a precedential matter that the Commission not adopt a test in which the *mere presence* of a competitor is sufficient to justify deregulation.

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36 USTA Comments at 43 (citing *Policy and Rules Concerning the Interstate, Interexchange Marketplace,"* CC Dkt. No. 96-61 (released October 31, 1996) at ¶ 14).

37 USTA Comments at 45.

This is especially true since the tariffs under which ILECs' co-location services are offered are still under investigation.[38] The investigation embraces all aspects of the ILECs' tariffs, including direct costs, rate structure, and terms and conditions, as well as some twenty sub-issues. It has been over two years since the initial co-location tariffs subject to the investigation were filed, yet the ILECs' "competitors" that need to interconnect with the ILEC monopoly facilities to compete continue to have to purchase those interconnection services at prices that may still be found to be excessive, under terms and conditions that could be held to be unduly restrictive.

To allow the ILECs to charge their competitors excessive prices for interconnection, while deregulating the prices for the dedicated transport services with which those same newcomers are attempting to compete, would be adding insult to injury, and would likely have a negative impact upon the ultimate level of competition for dedicated transport facilities.

IV. The ILECs Should Not Be Given New Opportunities for Earnings Growth Unless they Shoulder a Symmetric Risk of Loss in the Value of Certain Tangible Assets.

The ILECs' claimed entitlement to be "made whole" with respect to prior investments is premised on the notion that such investments were in all instances made by them in fulfillment of their public service obligations, and that as regulated public utilities their "social contract" with the public imposes upon

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[38] *In the Matter of Local Exchange Carriers' Rates, Terms and Conditions for Expended Interconnection Through Virtual Collocation for Special Access and Switched Transport,* Docket 94-97, Phase II, Order Designating Issues for Investigation, September 19, 1995, 10 FCC Rcd No. 21, at 11116.

the public the obligation to absorb all business risks associated with those capital commitments. Deferring, for the moment, the matter of whether, in fact, all ILEC investments were made by them in fulfillment of their public service obligation, the "social contract" proposition has validity only so long as it is symmetrically applied. That is, if ratepayers are to bear the risks and, through rate levels expressly intended to assure full cost recovery, all of the costs of the ILECs' capital asset base, then, as a matter of sound public policy and law, they are entitled to reap any extraordinary financial benefits arising from their commitment to underwrite the costs and risks of those assets.

In *Democratic Central Committee of the District of Columbia v. Washington Metropolitan Transit Commission,* 485 F.2d 786 (D.C. Cir. 1973), *cert. denied,* 415 U.S. 935 (1974) ("*DCC*"), the Court of Appeals for the D.C. Circuit articulated the principle that "reward follows risk and benefits follow burdens."[39] The Court explained this principle as follows:

> In situations where consumers have shouldered these burdens on an asset which produces a gain, the equities clearly preponderate in their favor. . . . [I]t is eminently just that consumers, whose payments for service reimburse investors for the ravages of wear and waste occurring in service, should benefit in instances where gain eventuates -- *to the full extent of the gain.*[[40]]

[39] *DCC,* 485 F.2d at 810. In *DCC,* the Court of Appeals invalidated an order of the Washington Metropolitan Area Transit Commission that established fares for a transit utility without taking into account the effect of appreciation of the utility's capital assets, some of which the utility retained, and others of which the utility had either sold or transferred to a wholly owned subsidiary. 485 F.2d at 788.

[40] *Id.* at 810 (emphasis added, footnote omitted).

The Court reasoned further that

> [t]he ratemaking process involves fundamentally "a balancing of the investor and the consumer interest." The investor's interest lies in the integrity of his investment and a fair opportunity for a reasonable return thereon. The consumer's interest lies in government protection against unreasonable charges for the monopolistic service to which he subscribes.[[41]]

The Court then cited two principles that should guide the Commission in this proceeding: First, "the right to capital gains on utility assets is tied to the risk of capital losses. " Second, "he who bears the financial burden of particular utility should also reap the benefit resulting therefrom."[42]

Under the principles laid down in *DCC,* if ILECs are to be assured full investment recovery, as they desire, then their financial gains from exploitation of those assets must inure to their ratepayers, not their investors. Thus, a "make whole" approach requires full, essentially symmetric application of rate of return regulation, in which the ILECs are protected from downside losses and revenue erosion while ratepayers are protected against prices set at supracompetitive levels.

In the instant proceeding, application of *DCC* would result in the ILECs' shareholders (rather than ratepayers) bearing the risks as well as the cost burdens in exchange for the opportunity to maximize their earnings from such

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41 *Id.* at 806.

42 *Id.* These principles have subsequently been reaffirmed and applied by the Court of Appeals in *Southwestern Bell Corporation v. FCC,* 896 F.2d 1378, 1381-82 (D.C. Cir. 1990), and *AT&T Information Systems, Inc. v. FCC,* 854 F.2d 1442 (1988).

undertakings. (Of course, the Commission should not give the ILECs this opportunity in any market that lacks a meaningful level of actual competition.)

But here, the ILECs are seeking to shed all risk by invoking fifth amendment protection, while claiming an absolute right to retain all excess earnings without returning a penny to their ratepayers. *DCC* does not, and the Commission should not, permit such asymmetric treatment of burdens and benefits.

V. The Ad Hoc Committee's "Make-Whole-or-Make-Money" Solution Would Address ILEC Concerns That the Prescriptive Approach Would Result in "Confiscation."

Several commenters contend that adopting rates set at forward-looking long run incremental cost will result in an unlawful "taking" of property in violation of the fifth amendment of the U.S. Constitution because it would prevent them from recovering their earlier capital investments.[43] Ad Hoc strongly disagrees with this contention, for the various reasons set forth above and in considerable detail in the Committee's initial comments.[44]

However, in the event that the Commission is concerned that the ILECs' "takings" argument may have merit, it should consider implementing an arrangement during the transition to a competitive environment whereby ILECs would be offered the opportunity to choose between (1) the no earnings cap/no earnings sharing feature of the present price cap system[45] (without any assured

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[43] *See* Initial Comments of Pacific Telesis at 44-45; Initial Comments of Bell Atlantic/NYNEX at 16-17. *See also* Initial Comments of GTE at 87.

[44] Ad Hoc Comments at 56 - 58.

[45] Price Cap Fourth FNPRM at ¶ 112. Of course, ILECs' earnings may never lawfully rise to a level where they would be unreasonable.