perspective,[75] but whether the ILEC investments were prudent when made. That question has already been answered; the ILEC investments were prudently made.[76]

Over the years prior to, and since divestiture, ILECS have been subject to a number of rate proceedings involving the access charge structure. These proceedings have all addressed whether the rate structure used by the ILECs (or imposed upon the ILECs) was reasonable. The reasonableness of the costs was assumed or determined. The prudency of the investments that were included in those costs was, therefore, also assumed or determined.

Specifically, in the LEC price cap docket (CC Docket No. 87-313), the Commission addressed in detail the reasonableness of July 1, 1990 ILEC rates. The Commission detailed many of the proceedings[77] that examined ILEC rates prior to 1990 and found that these rates were "the best that rate of return regulation can produce."[78] The Commission explicitly rejected using a rate case to re-examine ILEC costs. These rates were based on essentially the same categories and accounts of costs as those borne by the ILECs today. Thus, the current ILEC investment should continue to be considered reasonable and prudent.

The legal issues could not be more clear. When prudently incurred costs have not been recovered, the regulatory environment <u>must</u> provide ILECs with a reasonable opportunity to recover these costs.[79]

Some parties incorrectly claim that the ILECs have asserted that their capital assets were acquired with expectation that their regulated and protected monopoly status would continue.[80]

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[75] AARP, p. 8.

[76] "Nor can the historic costs of providing network infrastructure, or the cost characteristics that inhere to such a network on a going-forward basis for the remainder of its useful life, be said not to have been 'prudent' or 'efficient' when asset-specific investment were made, or not to have resulted from a bargain between regulators and the LEC." Sidak/Spulber Reply, p. 2.

[77] Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd 6786 (1990), paras. 232-240.

[78] 5 FCC Rcd 6786, para. 232.

[79] USTA, Attachment 3, Sidak and Spulber, pp. 33-62.

[80] <u>See</u>, e.g., Ad Hoc, p. 55.

Nothing could be further from the truth. ILECs have persistently requested that the Commission modernize its regulations to recognize the more rapid changes in technologies, changing customer needs and the increases in competition.[81] It would be unlawful to now penalize the ILECs for failure to make use of any supposed opportunities for recovery of embedded costs when those opportunities actually were precluded by the Commission.

Implementation of price cap regulation was neither an abdication of the Commission's responsibility to provide the ILECs a reasonable opportunity for a fair return on investment nor a statement that investments made after the start of price cap regulation should be viewed as imprudent.[82] Under price cap regulation ILECs were still required to serve all customers, no matter the cost. ILECs continued to make prudent economic investment and expense decisions while being constrained by regulation in many ways. The prudency of the ILECs' investments and costs were assured predominantly by the discipline of considering financial returns to shareholders and the requirement that alternative capital projects compete among each other for scarce capital funds. Moreover, due to the endogenous nature of these costs under price cap regulation,[83] ILECs did not receive any explicit rate recovery for any general network investments, equal access costs, depreciation rate changes or virtually any other increase in investments or other costs incurred after 1990. The introduction of price cap regulation did not end the obligations of either the regulated firms or the regulators.

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[81]See SWBT's Comments (filed 11/1/93) and Reply (filed 11/16/93) in RM-8356 (USTA's Petition for Rulemaking on Access Reform). Also, *see* SWBT's Comments in response to the FCC Staff paper on Interstate Access Charge Reform (filed 9/23/93). And, *see* SWBT's Comments in CC Docket No. 90-11 (AT&T's Tariff No. 15 Filing), filed 5/21/92.

[82]API, p. 39; AARP, pp. 6-7.

[83]Also, price cap regulation did not give LECs the pricing flexibility that is inherent in a competitive environment, nor did it allow LECs to reflect an adequate amount of regulated depreciation expense. Thus, the ILEC sharing obligations were overstated, further reducing investment incentives.

Some parties claim that ILEC investments in advanced technologies (e.g., SS7, ISDN, Centrex) were made for strategic reasons, implying that these investments were not made in response to customers' needs and, therefore, were not prudent.[84] The Commission must recognize that these advanced technologies and services (SS7, database capabilities, high capacity services, survivability, and other advanced network investments) were deployed in response to expressed customer needs and specific regulatory mandates. MCI claims that access customers do not need advanced capabilities, while, MCI markets itself as a company that provides the latest advanced capabilities. Such claims are transparent.

B. FCC PROXY OR HATFIELD TELRIC PRICES ARE INAPPROPRIATE.

Even in competitive markets, rates are not equivalent to the Commission's concept of TELRIC or TSLRIC.[85] Setting prices at TELRIC plus an allocated share of forward-looking common costs may not allow a LEC to recover its actual costs. Regardless of whether one looks at costs via TSLRIC (on a service basis) or TELRIC (on an element basis, which purportedly "minimizes" common costs), there are still significant LEC costs that cannot be attributed directly to services or elements, plus significant overheads. No firm can be reasonably expected to attract equity capital if it does not have an opportunity to recover its actual costs and earn a return on its investment.[86]

AT&T and other commentors in this docket have argued that the TELRIC pricing of access should be adopted.[87] However, this pricing proposal for access raises critical questions of cost recovery and the ultimate achievement of the goals and objectives of Congress in passing the 1996

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[84]AARP Attachment 1, p. 25. Using convoluted logic, Selwyn "guesstimates" that 20% of network investment since 1990 cannot be explained by basic service needs. (What about interstate access service needs?)

[85]See, SWBT, pp. 47-48 (citing Alexander C. Larson "A Price Is Not a Formula," 134 Pub. Util. Fort. 13 (September 1, 1996)).

[86]"TELRIC pricing *guarantees* losses and thus is inherently confiscatory. A policy that required TELRIC pricing would therefore violate section 252(d)(3) and constitute a taking." Sidak/Spulber Reply, p. 5.

[87]AT&T pp. 18-20; CPI, p. 22; EXCEL, pp. 6-7, 14; IXC LD, pp. 2-3; LCI, pp. 16-17; Sprint, p. 7; TRA, pp. 21-23.

Act. TELRIC-based pricing of access charges is the incorrect method of reforming access prices, and would be incorrect even in a fully competitive market. Sole reliance on "forward-looking economic cost" as a basis of prices is fraught with pitfalls that can derail the benefits of an access reform policy, with significant spill-over effects into the ongoing implementation of the 1996 Act.

Access prices must either contain a suitable margin above incremental cost or the Commission must establish public policy mechanism(s) to provide recovery of actual costs. A suitable margin above incremental cost is typically necessary for recovery of actual costs that are incurred on an ongoing basis. This is also true of highly competitive industries. The IXCs claim it is reasonable for them to charge rates several times their own incremental costs.[88] Because telecommunications firms have relatively low variable costs and high fixed costs, prices must generally exceed incremental costs or TELRIC by a potentially high margin. Firms seeking access to SWBT's facilities to pursue their own business strategies have an opportunistic reason to argue for low access charges to the detriment of SWBT's cost recovery. The Commission should not be swayed by specious and opportunistic arguments that ignore the ILEC investments and expenses required to provide access services.

Commentors such as AT&T have been completely silent on the issue of how past investments affect forward-looking incremental costs. Any firm will only change out its current stock of invested capital, and replace it with new more efficient capital and equipment, if the short-run avoided costs of continuing operation exceed the net present value of buying and operating new equipment. The IXCs do not change out their network equipment the minute a newer more efficient piece of equipment becomes available; no firm would or could do so. Prices in robustly competitive markets should generate revenues that recover actual costs not only current costs. No IXC favoring TELRIC-

[88]Letter from Alfred E. Kahn to Reed E. Hundt (Jan. 14, 1997), at 4.

based pricing of access can explain why it thinks it makes sense for a LEC to replace its network from scratch and offer access services at TELRIC-based prices.

AT&T[89] and MCI[90] state that the difference between the LECs current access revenues and the hypothetical TELRIC costs calculated by the Hatfield Model represents various uneconomic costs.[91] Nothing could be further from the truth; it is simply a comparison of a hypothetic non-existent network with an actual evolving network. The revenue levels achieved by LECs reflect the actual costs to the LECs of providing an efficient network to customers with a high degree of penetration. The Hatfield Model uses estimates of the numbers of customers, evenly distributed over a hypothetical square area, with cable/fiber placed on a rectilinear basis at optimum capacity for only the current number of customers, using equipment/material at unobtainably low prices, and using a theoretical network design that has not been validated. The network represented by the actual costs/revenues works -- the hypothetical network represented by AT&T/MCI/Hatfield has been shown to be incapable of actually providing service.[92]

Both MCI and AT&T use the same version of the Hatfield Model for the "forward-looking cost tool" but they derive different answers. Using the information,[93] SWBT was not able to replicate any of the numbers generated by MCI. Using the "Total Loop - Annual Cost" from the Hatfield Model version 2.2.2 cost worksheets, (example: BellSouth, Alabama is $387,142,857) SWBT computed a Total Loop Cost for the 49 entities for which Hatfield data is available at

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[89]AT&T, p. 13.

[90]MCI, pp. 21-24.

[91]MCI states that these are "a combination of implicit subsidies, unrealized efficiency improvements, and assets acquired in preparation of entry into video and long distance markets." none of which are proven with any sort of validity.

[92]*Engineering Evaluation of Cost Proxy Models for Determining Universal Service Support: Hatfield Model 2.2, Release 2,* A Paper by Dr. Robert F. Austin dated February 5, 1997, presented to the FCC Staff on February 5, 1997 in an ex parte by USTA in CC Docket No. 96-45. For example, this paper identifies cases of untreated loops on copper that are almost 100,000 feet long when the engineering limit to provided dial tone and voice transmission over untreated copper loops is 18,000 feet (p. 30). This paper is attached as Attachment Austin. Also attached to show the inaccuracies of the Hatfield Model are Attachments Conwell, Taylor, SA-MO and SA-TEXAS.

[93]MCI, p 21.

$20,775,884,785. With no way to replicate the "cooked books" presented by AT&T and MCI, the assertions made based on this spurious misinformation should be disregarded.[94]

Actual data should be used for purposes of determining the reasonableness of individual parties' assertions. The following data is provided as an example of how readily available data can be used to make such comparisons.

TOTAL INTERSTATE COMMON LINE COSTS SWBT - TEXAS
SOURCE ARMIS 43-04 - 1995 (Column i)

DESCRIPTION	Source ARMIS 43-04 Row Numbers	Amount (Dollars in thousands)
Plant Specific Expense	5060	$151,777
Total Plant Non-Specific Expense	6270	$174,625
Marketing Expense	7000	$17,390
Other Customer Service Expense	7310	$19,378
Corporate Operations Expense	7334	$52,992
Total Operating Expenses	Sum of above	$416,162
Total Operating Taxes	8030	$51,139
Average Net Investment (ANI)	8040	$1,036,157
Return @ 11.25%	ANI times 11.25%	$116,568
Revenue Requirement (Op. Exp. + Op. Tax + Return)		$583,869

Contrast this cost derived from following the FCC imposed regulatory procedures for Accounting (FCC Part 32), Jurisdictional Separations (FCC Part 36) and Access Charge Rules (FCC Part 69) with the hypothetical cost created using MCI's methodology:

MCI METHODOLOGY FOR HYPOTHETICAL INTERSTATE COMMON LINE COST

ROW	DESCRIPTION	SOURCE	COST (Dollars in thousands)
1	Total Loop - Annual Cost	Hatfield Model, Version 2.2.2	$1,351,375
2	Allocation to Interstate	25%	$337,844
3	Growth at 6%	Row 2 times 6%	$20,271
4	Total IS Common Line	Row 2 plus Row 3	$358,114

[94]Multiplying the $20,776 million times 25% and 1.06 as MCI indicated in its footnote 34(a) on page 21 produces $5,506 million, instead of the $5,592 million shown on MCI's Table III-1.

MCI's methodology produces a cost that is only 62% of the actual interstate loop cost associated with providing service, completely ignoring the Commission's rules that determine how costs of providing facilities should be accounted and allocated to the interstate jurisdiction.

The Hatfield Model does not even reflect a reasonable estimate of the costs of providing service. If one were to total up the costs from the Hatfield Model 2.2.2 output for all categories that are specified the total would be $30,075,890,938. The total operating expense from line 280 of the FCC's 1995 Statistics of Communications Common Carriers (SOCC) shows a total of $56,831,094,000 for the seven RBOCs. In addition, the SOCC identifies $7,616,020,000 of Operating Taxes on line 293 and an average net investment of $122,221,777,000 on line 97 of Table 2.9. Using a rate of return of 11.25% (the FCC authorized interstate rate of return), a total RBOC actual cost of $78,203,175,000 can be computed. Hatfield/AT&T/MCI's calculation would only allow recovery of 38% of the RBOCs' Total Cost. Thus, all claims presented by AT&T and MCI based on the Hatfield Model should be rejected.

C. ACCESS PRICES SHOULD BE APPLIED TO UNBUNDLED NETWORK ELEMENTS

Several parties oppose the application of Part 69 access charges to unbundled elements. ACTA believes unbundled elements should be excluded from the current Part 69 regime.[95] CPI supports the Commission's tentative conclusion that unbundled elements should be excluded from Part 69 regardless of whether services are used to provide exchange access.[96] Sprint believes the applicability of access charges to unbundled elements has already been resolved.[97]

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[95]ACTA pp. 3-4.
[96]CPI pp. 11, 26.
[97]Sprint opposes the application of access charges to unbundled elements, Sprint pp. 9-10.

The Commission's Interconnection Order established price levels for unbundled network elements that fall far short of recovering actual costs. The table below demonstrates that in aggregate, actual costs exceed unbundled network element revenues per line in all cases. In fact, the unbundled network element prices do not even cover the intrastate allocation (approximately 75%) of actual costs determined by the separations process. Therefore, no party can make the claim that unbundled network element revenues per line are recovering the interstate allocation of actual costs.

Unbundled Network Element (UNE) Rates Do Not Recover Actual Costs
(Dollars Per Line Per Month)

*Basis**	*Arkansas*		*Kansas*		*Missouri***		*Oklahoma*		*Texas***	
	Bus	*Res*	*Bus*	*Res*	*Bus*	*Res*	*Bus*	*Res*	*Bus*	*Res*
Retail Rev.	*57.83*	*42.32*	*56.75*	*42.76*	*58.72*	*37.28*	*51.56*	*35.16*	*55.10*	*38.16*
UNE Rev.	*32.68*	*32.68*	*30.43*	*30.43*	*27.11*	*22.92*	*28.49*	*28.49*	*26.93*	*25.13*
Actual Cost	*52.31*	*52.31*	*52.67*	*52.67*	*49.28*	*49.28*	*45.93*	*45.93*	*46.95*	*46.95*
Intra-state Actual Cost	*39.23*	*39.23*	*39.50*	*39.50*	*36.96*	*36.96*	*34.45*	*34.45*	*35.21*	*35.21*

* UNE revenues are derived from unbundled network element rates. Retail revenues include all local, toll, access, vertical services and SLC revenue. Actual costs are SWBT's embedded costs per line. Intrastate actual costs are estimated at 75% of actual costs.

** Missouri and Texas UNE revenues are from Arbitration Orders; all other UNE revenues are from the Commission's Interconnection Order. The UNE revenues from the Commission's Interconnection Order for Missouri and Texas are $34.44 and $33.28 respectively.

The Part 36 Rules did not change as a result of the Commission's Interconnection Order. The Part 36 Rules continue to assign a portion of all facilities and operating costs to the interstate

jurisdiction. Interstate access charges are the only method a carrier has to recover its interstate costs. In its customer premises equipment (CPE) and inside wire decisions, the Commission permitted interstate cost recovery of these facilities in recognition of the separations process. Additionally, as the Commission stated, regarding application of the SLC:

> any costs of service assigned to the interstate jurisdiction as a result of the separations process (which obviously must be recovered through interstate charges of some type) should be recovered through interstate charges on the services and customers that cause the costs to be incurred[98]

Thus, it is essential that interstate access charges be applied in order to recover the interstate allocation of actual costs.

D. THE OPPORTUNITY TO RECOVER ACTUAL INTERSTATE BOOKED COSTS IS PROTECTED BY LEGAL PRECEDENT.

Regulators must address the problem of recovery of actual stranded costs before the growth of competition in the industry makes it more difficult to address that problem. One might believe, however, from a reading of the out-of-context quotes on this issue,[99] that the Commission is free to reject any claim for virtually any investment made by the ILEC. The standard espoused by the Fifth Amendment for example, according to one party, AARP, is: "It shields them, at best, only from the most dire financial outcome -- bankruptcy."[100] This reading, made without any direct citation to any case law, is wrong.[101]

The relevant law read in context, states otherwise. The first quote of SCA is to Duquesne. While the quote is accurate, Duquesne also noted that the "regulatory scheme" under which the

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[98]Iowa Telephone Association Petition for Declaratory Ruling, (FCC 85-228) (released May 7, 1985) (discussing application of the SLC).

[99]SCA, pp. 55-57; AT&T, pp. ii-iii; Time Warner, p. 46.

[100]AARP, p. 6.

[101]While the AARP does cite to the Joint Brief in the Interconnection Order Appeal (Case No. 96-3321) filed by CFA and the National Ass'n of State Utility Consumer Advocates, it is noteworthy that the cited brief does not refer to a "bankruptcy" standard in its discussion of the relevant case law. One may wonder why these parties submit an opinion of the standard here that they did not consider correct enough to submit to the court.

investments in question were denied, did not raise any claim that the "financial integrity" of the companies was jeopardized or that shareholders would not be adequately compensated. The reason these arguments were apparently not made in Duquesne is that the Pennsylvania regulatory scheme provided other methods of recovery to the companies so as not to depress their earnings below a constitutionally infirm level.

Contrary to SCA's and AT&T's positions, using revenues from unrelated sources to "prop up" underrecovering rate elements is not how the Commission engages in ratemaking. The Commission has reviewed earnings in categories to determine whether companies are overearning. As the Commission has itself described its methodology:

> Under the category-by-category approach of both the 1981 prescription and Phase I Order, AT&T is afforded a reasonable opportunity to recover all of its costs, including a return on capital. There is no guarantee of any return, nor is the "opportunity" without reasonable restrictions. We have determined, for example, that it must recover its capital costs by earning a reasonable return on each of its services; it cannot offset deficient private line earnings with excessive earnings from switched services. Our obligation under the Communications Act to ensure just and reasonable rates compels us to prevent one class of customers from paying excessive rates or cross-subsidizing other customers.[102]

Thus, the scheme used by the Commission must pass Duquesne muster by requiring that the appropriate ratepayers pay the proper amounts. The Commission cannot require one group of ratepayers (i.e., customers of unregulated services) to pay for investment that is now being used to provide regulated service.[103]

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[102]Authorized Rates of Return for the Interstate Services of AT&T Communications and Exchange Telephone Carriers, 59 Rad. Reg. 2d (P&F) 1592 (1986), at para. 10.

[103]AT&T (pp. 35-37) and MCI (pp. 48-55) argue that ILECs have ample revenue sources to cover shortfalls resulting from underrecovery of actual costs for access services. First, AT&T claims that under price caps ILECs are allowed to earn premium returns if they operate efficiently. Greater earnings opportunities (not guarantees) are the feature of price caps that simulates incentives of competitive markets.

AT&T (p. 37) points to other potential revenue sources, notably vertical service revenues. AT&T ignores the reality that negotiated unbundled local switching arrangements require ILECs essentially to give away many of their custom calling features, erasing erstwhile revenue potential.

Some parties have suggested that the current market value of the unregulated operations of RBHCs is more than adequate to offset the loss in value that would be associated with setting interstate access rates at TSLRIC/TELRIC levels. (See, e.g., Ad Hoc, pp. 59-

SWBT disagrees with ALTS and AT&T[104] that it is premature to discuss whether any changes to the access charge structure are a "taking." On the contrary, whether a "taking" will occur, must be dealt with now, even if only in the abstract. ALTS claims that the proper time is when "the final version of access charge reform is ready for implementation." However, the "final version" of the Commission's plans is being devised now from this NPRM. The final rules (according to Commission sources) will be seen in a few months and presumably will take effect quickly. It may be too late to fix the rules at that point. If the rules constitute a "taking," the losses will almost immediately be incurred. The correct scenario is to ensure that the rules as contemplated do not in any way cause a "taking" so that no extraordinary remedies will be needed after the rules take effect.[105]

Likewise, AT&T's suggestion, that ILECs that claim confiscation be required to go through a "waiver" process, should also be rejected. The availability of a waiver process would not cure problems with an access rate structure that is illegal ab initio.[106]

Sprint admits that its plan for a prescriptive move of all access elements to TELRIC levels is not revenue neutral to ILECs.[107] However Sprint "minimizes" the problem by providing that ILECs would have five years to manage revenue shortfalls. Simply expecting ILECs to manage the loss of

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61.) AT&T wrongly expects ILEC services such as "yellow pages, customer calling services, enhanced services, and Block B cellular franchises" to cover embedded cost shortfalls from access. Several of these services are offered through separate subsidiaries precisely designed together with imputation rules, to preclude alleged cross-subsidization. More importantly, heaping substantial additional cost recovery expectations on the above services -- all of which face substantial competition -- in order to "prop up" mandated underrecovery in access would be a most imprudent business decision for any firm, including AT&T.

These contentions also completely misconstrue the concept of ownership. Just because a customer has purchased a product or service he/she does not lay claim to the underlying assets of another subsidiary of the company. "The only profit that is relevant for purpose of section 252(d)(1) is the profit on the incumbent LEC's *regulated* services," and "It is impermissible to judge whether regulation is confiscatory by including the returns to unregulated operations of the company in question,'" quoting *Brooks-Scanlon Co. v. Railroad Commissioner*, Sidak and Spulber Reply, pp. 58-59.

[104]ALTS, p. 27; AT&T, fn. 67.

[105]SWBT might be convinced to "wait and see" if the rules were set out for further comment before they take effect. Unfortunately, the timing of this docket and the immediate need for access rate restructuring, do not appear to permit that type of review.

[106]U.S. v. Western Electric, 907 F.2d 160, 163 (D.C. Cir. 1990).

[107]Sprint, p. 51.

this substantial revenue shortfall over time does not make these financial losses any less damaging or less illegal.

E. THE PROSPECT OF A PRICE SQUEEZE IS UNREALISTIC.

In the NPRM,[108] the Commission pointed out that IXCs typically advance a basic argument: if access services are not available at their forward-looking economic cost, incumbent LECs and their long distance ("LD") affiliates will have an unfair competitive advantage in the market for long distance services. The basis of this specious argument is as follows: for the incumbent LEC's long distance affiliate, the effective cost of obtaining "in-region" access service is the incremental cost that the affiliate incurs in providing access. Supposedly, then, if an incumbent LEC that also provides long distance service can charge unaffiliated IXCs access prices significantly higher than forward-looking economic cost, the incumbent LEC can create a "price squeeze" by raising rivals' costs. It is further argued that the LD affiliate of the incumbent LEC could lower its retail LD price to reflect its "cost advantage," and competing unaffiliated IXCs would be forced either to match the price reduction and absorb overall profit margin reductions or maintain their prices at existing levels and accept reductions in their market shares.

Specifically, AT&T advances the argument that LECs have the opportunity to "price squeeze" their long distance competitors by raising prices of bottleneck services and lowering prices in competitive downstream markets.[109] AT&T argues, erroneously, that to the extent access charges exceed economic costs, an ILEC enjoys a lower cost of providing long distance services than

[108]NPRM at ¶¶47, 148.
[109]AT&T, pp. 14-15.

competitors who must pay "excessive" access charges.[110] Other commentors in this docket make the same or similar arguments.[111]

As an initial matter, price cap regulation prevents LECs from raising access price to levels necessary to execute a "so-called" price squeeze. Second, the price squeeze argument of AT&T and other commentors is specious, primarily because there is no "cost advantage" (aside from legitimate technical or managerial efficiencies) accruing to the long distance affiliate of a LEC. In-region interexchange services must be offered through a separate subsidiary.[112] Contrary to the arguments of the IXCs, the long distance affiliate's effective cost of obtaining "in-region" access service is *not* the incremental cost its affiliated LEC incurs in providing access; it is the *same rates*, under the same terms and conditions, that its long distance rivals have available to them from an ILEC or alternative source of access. The ILEC will charge the same access rates to its LD affiliate as to other IXCs. As the Commission itself pointed out in the NPRM, this provides protection against possible anticompetitive conduct, hence there is no need to create any further constraints or to mandate TELRIC pricing for access.[113]

Thus, it is not possible for an incumbent LEC's affiliate to lower its retail price to reflect a nonexistent "cost advantage" (*i.e.*, the incumbent LEC's incremental cost of providing long distance versus the access charges unaffiliated IXCs pay). Due to efficiencies borne of superior technical or managerial ability, and the competitive process, it may be possible for LEC affiliates to force competing unaffiliated IXCs either to match the price reduction (and absorb overall profit margin reductions) or maintain their prices at existing levels and suffer reductions in their market shares.

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[110]Id. at 15.

[111]CPI, p. 21 (arguing that access prices must be set at TSLRIC to ensure fair competition as BOCs enter the long distance market); EXCEL, pp. 4-5; Sprint, p. 3 (arguing that high access rates give RBOCs a huge advantage vis-a-vis their long distance rivals, and that it is necessary to get access prices to cost to allow local entry); Telco Com Grp, p. 4.

[112]47 U.S.C. §272(a)(2)(B).

[113]NPRM at ¶198.

This is what true competition is all about. However, there is no undue advantage accruing to the LD affiliates of ILECs due to lower access costs.[114]

In summary, the price squeeze scenario argued by the IXCs is impossible; and it has nothing to do with prices of access services exceeding forward-looking economic cost.[115]

F. DEPRECIATION RESERVE DEFICIENCY RECOVERY ISSUES MUST BE SOLVED IMMEDIATELY.

For decades, depreciation lives have been prescribed by the Commission and have not matched economic lives. These policies have resulted in an accumulation of under-depreciated plant. SWBT has calculated a reserve deficiency amount based upon the excess net book value of LEC plant over the net book value that would have existed if depreciation lives had been set at economic levels. SWBT proposes to amortize this amount over a five year period. SWBT also proposes to recover this annual amortization with a specific capital recovery charge. This charge would be applied to IXCs based upon their three year historical share of interstate access charges paid to SWBT. Additionally, the Commission should permit ILECs to set economic depreciation lives on a going forward basis which would prevent any future under-depreciation problems. SWBT addresses claims raised by other parties regarding depreciation in an attachment by its expert witness on capital recovery.[116]

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[114]Further, the availability of unbundled network elements (even at prices exceeding FCC proxy TELRIC rates), self-supply and facilities of alternate suppliers make the concept of a price squeeze all the more moot because it comprises an alternative source of access services for IXCs.

[115]*See, e.g.*, Alfred E. Kahn, *Can Regulation and Competition Coexist? Solutions to the Stranded Cost Problem and Other Conundra*, ELECTRICITY J. 23, 34 (Oct. 1994)("In situations in which prices set at marginal costs would produce revenues insufficient to give the utility a reasonable opportunity to recover its total revenue requirement . . . all competing sellers should make a proportional contribution to that total, as part of the price they pay for access . . . . As long as the contribution required of competitors is no greater, on a per unit basis, than the contribution reflected in the [incumbent] utility's own charges to the same customers, all sellers will be in a position to compete on the basis of their relative efficiency.").

[116]"The ILECs' Depreciation Reserve Problem," John P. Lube, Attachment LUBE to these Comments.

G. SWBT'S PUBLIC POLICY RATE ELEMENTS ARE NOT A "MAKE WHOLE" DEVICE.

Some commentors criticize any cost recovery that seeks recovery of actual costs, describing these as "make whole" devices.[117] SWBT's proposal for public policy rate elements is not a request for guaranteed recovery of superfluous costs nor does it recover competitive losses. Public policy rate elements are legitimate, and the costs recovered have been scrutinized and approved by the Commission.[118] SWBT proposes three public policy elements.

The first is a flat rate charge to interexchange carriers for recovery of carrier common line charges previously assessed on a minute of use basis. Under SWBT's proposal, the flat rate common line charge would not be assessed to the carriers unless the customer is a LEC customer. If the Commission does not permit a full SLC to be billed to carriers that purchase an unbundled loop, then SWBT proposes to assess the carrier a common line public policy element charge. If the carrier purchases loops from another supplier then SWBT would not assess the common line public policy element. Therefore, SWBT is not shielded from competitive losses.

The second public policy rate element is for the recovery of transport averaging and tandem cost that cannot be recovered from tandem transport users due to public policy considerations. This charge is not assessed on carriers who use facilities-based alternative sources for transport and therefore, does not shield SWBT from competitive losses.

The third public policy rate element is a charge for those separated costs that appear to be misallocated to the interstate jurisdiction. This, like the other public policy elements, would be managed under price caps and would not be shielded from competitive losses.

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[117]AT&T p. 29-3; MCI p. 4.
[118]See SWBT's Comments, Section V.A. pp 40-47.

Telco Communications Group states, "in a competitive market, no firm is guaranteed recovery of its embedded costs."[119] However, parties that remain critical of ILEC objectives to seek recovery of actual costs fail to acknowledge that competitive firms do not face the same regulatory obligations that ILECs have and continue to face. ILECs must meet rigorous quality standards and ubiquitous service-on-demand requirements that resellers and rebundlers will not generally face. The clear expectation was assurance of cost recovery in exchange for abiding by these obligations. SWBT is not looking to recover costs for customers it loses to legitimate competition, as that would be an unfounded entitlement. SWBT does seek recovery of actual access costs incurred historically and currently for serving both its own retail and wholesale customers. This is a reasonable expectation.

IV. OTHER ISSUES[120]

A. THERE IS NO BASIS TO INCREASE THE X-FACTOR IN THIS PROCEEDING.

Several parties make baseless claims that the productivity offset (X-Factor) in the LEC price cap plan should be increased.[121] Evidence in this proceeding[122] and in the Price Cap Performance Review[123] demonstrates that the numerous conceptual and computational errors in the X-Factor

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[119]Telco Communications Group, p. 8.

[120]This section addresses NPRM Sections VI.C, D; VIII. A, C.

[121]AT&T, pp. 69-72; MCI, pp. 24-28; Ad Hoc, p. 70. See also, CARE ex parte, CC Docket No. 94-1, Fourth FNPRM, filed April 16, 1996.

[122]See USTA Comments: Attachment 5, "Updated Results for the Simplified TFPRP Model and Response to Productivity Questions in FCC's Access Reform Proceeding," Laurits R. Christensen, Philip E. Schoech and Mark E. Meitzen (Christensen Update); Attachment 6 "Critique of the AT&T Performance-Based Model." Christensen Associates (Critique of AT&T); and Attachment 7, USTA Ex Parte in CC Docket No. 94-1, "Response to MCI Productivity Analysis," (Response to MCI); and Attachment 4, "Affidavit of Dr. James H. Vander Weide" (Vander Weide).

[123]See USTA Comments, CC Docket No. 94-1, Fourth FNPRM, pp. 1-33, Attachment A "Total Factor Productivity Methods for Local Exchange Carrier Price Cap Plans including Response to Appendix F, Christensen, Schoech and Meitzen, Christensen Associates, and Attachment B, "Total Factor Productivity Review Plan," and Attachment C, "Economic Evaluation of Issues for the Fourth Further Notice of Proposed Rulemaking in the LEC Price Cap Performance Review," Taylor and Zarkadas, NERA, filed January 11, 1996 (?);. and USTA Reply Comments, CC Docket No. 94-1, Fourth FNPRM, pp. 6-21, Attachment A, "Total Factor Productivity Methods for Local Exchange Carrier Price Cap Plans: Reply Comments," Christensen, Schoech and Meitzen, and Attachment B, "Economic Evaluation of Issues for the Fourth Further Notice of Proposed Rulemaking in the LEC Price Cap Performance Review: Reply Comments," Taylor, Tardiff, and Zarkadas, NERA, filed March 1, 1996.

recommendations of AT&T, MCI and Ad Hoc lead to an inescapable conclusion that these proposals are not economically sound. SWBT demonstrated in its Comments that a productivity offset equal to or above the current levels used in the Commission's price cap plan would be excessive.[124] Also, USTA filed four relevant attachments in its Comments.

The Christensen Update presented updated total factor productivity (TFP) results through 1995. Those results show that, historically, LEC productivity growth has exceeded U.S. economy productivity growth by 2.7% per year.[125] Because the TFP approach is the only method for measuring productivity that is economically sound and has withstood the scrutiny of intense examination, the Commission is not free to arbitrarily adopt the unprincipled and unsubstantiated requests for a higher X-Factor. In fact, as SWBT has demonstrated, there is substantial rationale for reduction of the X-Factor below the adjusted 2.3% results supported by Christensen Associates.[126]

Productivity estimates based on historical studies will overestimate the productivity potential of the ILECs in a post-access reform, post-Act environment. As SWBT and Christensen Associates have both demonstrated, the effects of access reform and the new competitive environment will be to significantly discipline prices and reduce the need for a restrictively applied X-factor. SWBT recommends a zero X-Factor for Network Services Basket and an X-Factor for the Public Policy Basket equal to the 2.7% Christensen results reduced for effects of rate restructuring.[127]

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[124]SWBT, "Productivity Offset (X-Factor) Analysis," Appendix 5.

[125]SWBT, Appendix 5, pp. 1, 4; USTA, pp. 19-21, and Christensen Update, Table 2, p. 4.

[126]SWBT, Appendix 5, p. 2-4, 6; USTA, p. 19 and Christensen update, pp. 6-13.

[127]SWBT estimates a 2.3% X-Factor, given the restructuring in its proposed plan. Different restructuring would require different adjustments.

USTA's critique of AT&T demonstrates that the so-called "productivity" analysis of the study method relied upon by AT&T is one that is replete with errors and based on a series of fundamentally incorrect methods.[128]

USTA's response to MCI exposes the MCI methods as both conceptually bankrupt and computationally dishonest.[129] MCI never attempted to measure LEC productivity. MCI's expressed intent for its so-called "analysis" was to determine how large the X-Factor would have to be to force -- as a result of a single year's application of a new higher X-Factor -- the ILECs' average interstate accounting earnings back to its starting point from five years earlier. MCI claims to calibrate that X-Factor which would eliminate in a single year all of the financial incentives for increased efficiencies present in the LEC price cap plan since its inception. MCI's method is earnings management, disincentive regulation. This approach is beyond rehabilitation and cannot meet the Commission's criteria for an economically sound approach.

Moreover, MCI's computations, and therefore CARE's ex partes relying on MCI, are dishonest. Reduced to its essence, MCI's method essentially observes how "fast" the price cap LECs have "cooked" over a five-year period and incorrectly assumes that this same amount of "cooking" can be completed in a future single year. This results in "speed" calculations by MCI that are dramatically overstated. This approach would entirely wipe out any positive earnings of the price cap LECs. Further, as USTA shows, even if one decided to work within MCI's flawed ROR regulation framework, which the Commission should not, corrected math would reveal a much lower X-Factor estimate of 2.85%, very close to the Christensen productivity results.

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[128]AT&T's consultant, Norsworthy, incorrectly measures every component of productivity (i.e., capital input , labor input and materials, rents and services input, output, all from both a quantity perspective and a price perspective). The Norsworthy analysis recommended by AT&T must be completely disregarded. USTA, Attachment 6.

[129]In the earlier price cap review proceeding, MCI computed X-Factors based on the accounting earnings results of the price cap LECs. While USTA had already presented proper evidence that completely discredited the MCI approach, MCI and other members of the CARE group again attempt to rely on these flawed MCI computations. USTA, Attachment 7.

MCI's recommends an X-Factor calculated to be high enough to entirely eliminate more than 50% of interstate access revenue within a five-year period. That MCI obtains an estimate of a 15.2% X-Factor from its unprincipled method provides the Commission with no credible justification for MCI's baseless recommendation.[130]

AT&T claims that removing interstate loop cost recovery from price caps might actually raise the ability of LECs to achieve productivity. AT&T's "logic" is wrong. AT&T claims that by no longer assessing the CCL charge on a per-minute basis and removing all loop recovery from price caps, a larger portion of the LECs' regulated revenue would be recovered on a per-minute basis.[131] Thus, while AT&T is recommending reductions in the portion of LEC access prices to be billed on a per-minute basis, AT&T concludes that a larger portion of LEC price cap prices will be charged on a per-minute basis, requiring an increase in the X-Factor to above 8.8%. Implicit in AT&T's math is a terribly flawed assumption regarding the attribution of cost growth to the services AT&T would remove from price caps; by definition, AT&T must be incorrectly assuming that the costs associated with per-minute services would grow at exactly the same rate and be incurred exactly in proportion to the costs associated with the rate elements that AT&T would remove from price cap regulation. USTA, NERA and Christensen Associates have shown this assumption to be arbitrary and wrong and to lead to incorrect conclusions regarding the X-Factor.[132]

Also, the basis for AT&T's productivity offset to which it would add its recommended increase was not addressed in AT&T's Comments. USTA has already exposed the basic AT&T

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[130]MCI recommends a Consumer Productivity Dividend (CPD) of between 5.2% and approximately 13% per year (depending on how one interprets MCI's rather vague approach), claiming that the intent of the Consumer Productivity Dividend was a means to drive prices to economic costs. MCI is wrong. The Commission imposed a CPD to "assign the first price cap productivity gains to customers." Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd 6786 (1990).

[131]AT&T, pp. 70-71.

[132]USTA, p. 22; USTA Reply Comments, CC Docket No. 94-1, Fourth FNPRM, filed March 1, 1996, pp. 20-21, Attachment A, and Attachment B.

productivity analysis as riddled with numerical and theoretical errors. Thus, the AT&T suggestion that the Commission should add to those errors with an unfounded increase associated with Common Line rate restructuring is clearly wrong.

SWBT's access reform proposal does not immediately remove Common Line from price cap regulation. It is logical that the X-Factor should be reduced when interstate revenue growth is slowed, as would be the case when per-minute revenue growth is forfeited for per-line revenue growth in the restructuring of Common Line. SWBT and USTA both demonstrated that access reform rate restructuring will lower interstate revenue growth and the productivity potential of the price cap LECs.[133] Accounting for the major portion of the rate restructuring proposed by USTA, historical productivity differential results must be reduced by 0.4% per year to 2.3% per year.

AT&T suggests that, if access prices were set at its estimates of TELRIC levels, "a great deal" of additional demand for access would be stimulated.[134] AT&T incorrectly assumes "the tail is wagging the dog." The primary effect of any prescriptive price reduction would be the resulting reduction in access revenues caused by the price decrease. That some fraction of a mandated price reduction might be offset by demand stimulation is a very minor tertiary effect. Demand stimulation will have even less effect in the future access market due to the significant cross-price elasticity with UNEs. The competitive pressure on access rates that will come from IXC self-supply, other providers of access and the availability of UNEs means that there is little or no hope for ILECs to stave off competitive losses. First and foremost, any prescriptive access price reductions will be reductions in interstate revenues that will fundamentally affect the ILECs' ability to sustain any given

[133]SWBT, Appendix 5, pp. 2-4; USTA, pp 19-21 and Attachment 5, pp. 6-8.
[134]AT&T, p. 71.

level of productivity offset. In the access environment associated with implementation of the 1996 Act, demand stimulation will not be a logical rationale for increasing the X-Factor.

Finally, the Vander Weide Affidavit demonstrates that the accounting earnings results of the price cap LECs cannot serve as the basis for any recommendation that earnings results are reason to raise the X-Factor. Dr. Vander Weide demonstrates that the LECs' economic rate of return during the 1991-95 time period was significantly less than the Commission's 11.25% benchmark rate of return.[135] Dr. Vander Weide computes the economic rate of return on investment in the same manner as the ROR represcription methods used by the Commission in determining the benchmark 11.25% rate of return.[136] That achieved economic rate of return was 8.75% over 1991-95. Thus, no access price reductions are warranted due to the earnings results of the price cap LECs.

B. THE EXPIRATION OF EQUAL ACCESS AMORTIZATION PROVIDES NO REASON TO REDUCE RATES.

A few parties recommend exogenous reductions in interstate access rates associated with the expiration of a specific amortization of certain equal access costs booked to specific accounts.[137] The Commission has already reviewed this decision on several occasions and has concluded that no exogenous reduction is warranted.

The equal access reconfiguration amortizations were implemented by the Commission as a means of preventing rate shock and providing the LECs with an explicit legal guarantee of recovery of a specific subset of costs related to regulatory obligation of equal access implementation.[138] Two

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[135]Vander Weide, pp. 4-5 and Schedule 1.

[136]Dr. Vander Weide's economic rate of return ("ROR") calculations uses cash flows and market values (as used in the Commission's setting of the ROR benchmark). Accounting earnings, by contrast, use accrued accounting income, book values and other reporting conventions required by the Commission for its accounting earnings monitoring. Dr. Vander Weide's analysis demonstrates the significant inconsistencies that exist when parties use the current Commission ROR benchmark (which was established using one set of rules and market perspectives) to judge the accounting earnings results reported using another set of the Commissions rules (that are fundamentally at odds with the perspective utilized for the benchmark setting).

[137]AT&T, pp. 68-69 and Appendix F. See also, National Cable TV Assoc., p. 28.

[138]See, Petitions for Recovery of Equal Access and Network Reconfiguration Costs, Memorandum Opinion and Order, (FCC 85-628) (released December 9, 1985).

things have happened in the past several years -- (1) the completion of the amortization and (2) the end of any legal right by the LECs to claim any under recovery of these specific cost -- neither of which signal an exogenous reduction.

The specific equal access costs originally reflected in the amortization accounts now have been fully amortized. AT&T incorrectly claims that the ILECs' equal access costs have already been fully recovered.[139] The ILECs have significant equal access costs that remain. Even though the amortization period for the specifically identified equal access network reconfiguration costs has expired, many of the existing equal access costs still continue to exist. Switch enhancements made during that amortization period merely did not vanish upon the expiration of that amortization period. Many of the physical modifications remained as well as the accompanying software. Furthermore, significant amounts of the amortized costs related to maintenance and other types of expenses which also continued and would continue even in the presence of a switch replacement. Thus it is extremely naive to support the concept that even though the amortization period expired, there no longer exists a cost associated with providing equal access functions.

Each time an ILEC purchases a new digital switch, buys switch generic software that is equal-access capable, or maintains existing investments which support equal access capabilities, it incurs additional equal access costs. These more recent equal access costs essentially replace the specific amounts previously recorded in the accounts reflected in the specific amortization amounts for which a legal right was established. The magnitude of the current equal access costs are substantial and are spread across a wide array of specific Part 32 accounts. Thus, none of these more broadly-defined equal access costs were reflected in the amortization amounts referred to by AT&T and MCI and

[139]AT&T, p. 68.

none have been treated as exogenous in price cap regulation. That the ILECs' legal rights to obtain recovery from AT&T for a subset of past equal access costs has expired does not signal that equal access cost in total have gone down or gone away or that access rates should fall.

These facts demonstrate that exogenous treatment of the expiration of the equal access amortization would be an arbitrary focus on certain equal access costs to the exclusion of other equal access costs and would capriciously ignore the history of equal access costs (and investments in general) as endogenous.

C. THE RECORD DOES NOT SUPPORT ROR REINITIALIZATION.

Several parties suggest that the Commission should reduce the LECs' price cap indexes to levels that would re-target earnings to a specific rate of return. Such proposed "reinitialization" are nothing more than the reimposition of rate of return regulation and must be rejected.[140]

MCI restates evidence that it submitted in the Preliminary Rate of Return Inquiry that it claims "shows that a 10% rate of return will fully compensate LEC shareholders for the risk they have borne investing in LEC financial assets."[141] The Reply Comments filed by Dr. Randall Billingsley for USTA in March and April of 1996 effectively rebutted all arguments and contentions made by MCI in that docket.[142] His findings show that MCI's contention is still erroneous.[143]

GSA also recommends that "the Commission reinitialize LEC access charges on the basis of a newly prescribed rate of return that reflects current debt and equity return requirements."[144] GSA's suggestion does not address the compelling evidence presented by USTA in March and April of 1996 that supported maintaining the current 11.25% benchmark rate of return.[145] GSA references the

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[140]USTA Reply Comments, Sidak and Spulber, pp. 45-48, filed February 14, 1997.
[141] MCI, p. 25 and by reference MCI Comments, Attachment A, in AAD 96-28 and AAD 95-172.
[142]11 FCC Rcd 3651.
[143]USTA Reply Comments, Attachment 13.
[144]GSA, p. 20 and by reference to 10 FCC Rcd at 9064-65.
[145]11 FCC Rcd 3651.

change in Treasury bond yields during 1996, but completely ignores the fact that these same Treasury-bond yields have risen since the 11.25% benchmark return was validated by USTA in March and April of 1996.[146]

AT&T, through an Economics and Technology, Inc. ("ETI") affidavit prepared by Kravtin and Selwyn, contends that "high market-to-book values observed for ILECs indicate investors clearly do not believe ILEC rhetoric about the potential financial impact of competition or the erosion of earnings opportunities in the current regulatory environment."[147] This Kravtin/Selwyn statement is without supporting theoretical or common sense underpinnings. It completely ignores the fact that book values are backward-looking accounting entries. As Dr. Billingsley notes, book values are commonly significantly lower than market values and this implies that Kravtin/Selwyn estimated historical accounting returns significantly overstate true earnings. By contrast to the Kravtin/Selwyn approach, the market values used by investors are a forward-looking investor estimate of future earnings of the companies. Moreover, Kravtin/Selwyn mix results for the regulated telephone company with the total corporation, including unregulated subsidiaries. Thus, the market values in the Kravtin/Selwyn calculations use investors' earnings expectations for the future of both regulated and unregulated operations of the Regional Bell Holding Companies. These are inconsistent with the book values in the Kravtin/Selwyn calculations that are determined by the past investments and regulated depreciation decisions associated only with the regulated telephone company operations.

AT&T further contends that "ILECs have continually experienced overearnings vis-à-vis Standard and Poor 500 Companies in the period following adoption of price cap regulation."[148] Dr. Billingsley points out many errors in AT&T's consultants' findings. The ETI errors include their

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[146]USTA, p. 17.
[147]AT&T, Affidavit of Kravtin and Selwyn, ETI, pp. 17-18.
[148]AT&T Affidavit, p. 25.

use of achieved accounting returns that are based on the regulatory accounting conventions, not required returns and return on equity, rather than return on invested capital, as prescribed by the Commission.

It is important to note that in the ETI analysis, through 1994, the RBHC earned returns on equity are not much different than those of the S&P 500. A departure is apparent in ETI's results for 1995. ETI conveniently omits an adjustment to the book value of equity for SFAS 71 write-offs that they made to their market-to-book analysis for the same period. Thus ETI, in calculating its estimates of returns on equity ("ROEs") for 1995, uses book value data that are inconsistent and artificially and incorrectly biased. (Note that, due to the inconsistent data adjustments employed by AT&T's consultants, the ETI estimate of RBHCs' composite ROE incorrectly jumped from 18.1% in 1994 to 25.7% in 1995.) In addition, ETI contends, without any support, that its estimate of "overearnings" is "conservative due to higher risk of S&P 500 vis-à-vis RBHCs."[149] ETI's calculations are intentionally biased and can only lead to flawed impressions and faulty conclusions. The Kravtin/Selwyn analyses are irrelevant to assessing the ILECs' performance or capital costs.

D. REGULATION OF TERMINATING LOCAL SWITCHING IS UNNECESSARY.

Several parties have recommended that terminating access charges be prescribed by the Commission.[150] The parties claim that prescribed rates were necessary because LECs have no switch competition and could take advantage of the situation by increasing terminating access charges. In reality, SWBT studies indicate significant declines among SWBT's three largest interexchange carriers switched access demand growth in 1996. These IXCs that show declines in switched access purchases from SWBT have positive toll revenue growth, their total sales remain strong and pre-tax

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[149] Id., p. 26.
[150] CompTel, pp. 19-20; WorldCom, p. 92; C&W, p. 31; LCI, pp. 18-20.