pricing is fully compensatory, and provides a full opportunity to recover all forward-looking costs plus a contribution to common costs. For this reason, and because reinitialization would be only a one-time change, it could not undermine investor confidence. Moreover, it is frivolous to assert that the 1996 Act and the prospect of competition have taken investors by surprise. Indeed, if anything, empirical evidence suggests that investors are bullish on the ILECs under the new regime.[47] But even if reinitialization could be said to have any adverse effects on incentives (which it does not), "[t]he benefits of economically efficient pricing (both to ratepayers and to the development of competition) far outweigh any negative effects that re-initialization might have in terms of "dampening" the efficiency incentives of the price cap plans." Ad Hoc at 44.

BellSouth's assertion (at 44) that "there is no legal basis for the Commission" to reinitialize price cap indices, or otherwise to adjust current access charges, is also meritless. Even if, as BellSouth claims, the "Commission's authority to order LEC rate reductions is grounded in Section 205,"[48] that section fully authorizes the Commission to modify any existing rate, so long as it provides an "opportunity for hearing" and concludes that the existing rate is unjust, unreasonable, or otherwise unlawful. 47 U.S.C. § 205. Any reduction in access rates ordered by the Commission in this proceeding would undoubtedly satisfy these requirements. It is well settled that, unless a statute requires that a hearing be "on the record," which section 205 does not, a notice and comment procedure satisfies the requirement of a "hearing."[49] And the Commission's conclusion

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[47]See, e.g., Kravtin/Selwyn Reply (Appendix B), p. 14.

[48]Contrary to BellSouth's assertion, the Commission has previously concluded that it also possesses the power to "prescribe access charges" by virtue of its authority under Section 201(a) to order a "division" of charges between carriers providing "through service," MTS and WATS Market Structure, Third Report and Order, CC Docket No. 78-72, Phase I, 93 FCC 2d 241, 254-55 ("*Access Charge Order*"), recon., 97 FCC 2d 682 (1983), second recon., 97 FCC 2d 834 (1984), and that its inherent regulatory powers under Section 4(i) "would be sufficient to enable [the Commission] to adopt access charge" modifications "apart from the powers conferred by Sections 201(a) and 205." Id., 93 F.C.C. 2d at 259. Thus, Section 205 is not the sole ground of the Commission's authority to pursue access charge reform.

[49]See United States v. Florida East Coast Railway Co., 410 U.S. 224, 234-35 (1973) (notice and comment procedures sufficient even in ratemaking case); Railroad Commission of Texas v. United (continued...)

that existing rates are above cost and thus harm consumers of long distance services while distorting the possibility of meaningful competition, see NPRM at 41-49, amply supports the finding, which the Commission should make explicit, that existing rates are unreasonable. See Section I, supra.

BellSouth is therefore reduced to arguing (at 44) that the Commission may not depart from prior conclusions that then-existing access charges were not unreasonable. But whether an existing rate is "reasonable" ultimately depends on the Commission's assessment of competing policy objectives, and it is settled that an agency is permitted to change its assessment of the public interest so long as it gives a reasoned explanation for its departure from prior policy. See Office of Communication of the United Church of Christ v. FCC, 911 F.2d 813, 817 (D.C. Cir. 1990); Black Citizens for a Fair Media v. FCC, 719 F.2d 407, 411 (D.C. Cir. 1983); Greater Boston Television Corp. v. FCC, 444 F.2d 841, 852 (D.C. Cir. 1971). Contrary to BellSouth's contention, the Commission therefore clearly possesses the authority to modify the ILECs' current inflated access charges.

In short, as MCI points out (at 10-11), the "market-based" approach would amount to nothing more than giving large, wealthy corporations the freedom to engage in monopoly pricing prior to the advent of competition. That would be both counterproductive and unlawful. As the Texas OPC puts it, "If the Commission fails to prescribe an efficient pricing structure for access, it will prolong and delay the advent of full and effective competition in both the access and local exchange markets."[50]

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[49](...continued)
States, 765 F.2d 221, 227 (D.C. Cir. 1985); AT&T v. FCC, 572 F.2d 17, 21-23 (2d Cir.), cert. denied, 439 U.S. 875 (1978); Bell Tel. Co. of Pa. v. FCC, 503 F.2d 1250, 1264-68 (3d Cir. 1974), cert. denied, 422 U.S. 1026 (1975).

[50]Texas OPC at 4; see also Tenn. Reg. Auth. at 20 ("a more aggressive regulatory posture in the near term will ultimately allow for more expeditious deregulation").

C. There Is No Basis For Any Make-Whole Payments Designed To Address ILECs' Embedded Costs.

Nor does the possibility of claims for "make-whole" payments militate in favor of the "market-based" over the "prescriptive" approach. As AT&T predicted, the ILECs seek such payments irrespective of which approach the Commission adopts.[51] They do so even though they concede that any such make-whole payments are directly contrary to the market forces that the Commission is attempting to replicate, because competitive markets provide no such devices to indemnify or cushion the impact of competitive entry and revenue loss.[52] For these reasons, as the Florida PSC points out (at 10), the burden should clearly be on ILECs to justify any make-whole payments for embedded costs.

Make-whole claims raise two questions: first, whether such a recovery is required by law, and second, whether that recovery should be permitted as a matter of equity or fairness. The ILECs have conspicuously failed to prove either.

As to the constitutional claim, it is well settled that there is no constitutional guarantee that utilities can recover their historical costs. Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989); Market Street Railway Co. v. Railroad Commission of California, 324 U.S. 548, 567 (1945); Illinois Bell Tel. Co. v. FCC, 988 F.2d 1254, 1263 (D.C. Cir. 1993).[53] A rate order is not unconstitutional unless, taken as a whole, it threatens the financial viability of the firm. Duquesne, 488 U.S. at 312. The LECs have not come close to making such a showing,[54] and indeed the

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[51]GTE at 81 ("Importantly, the ILECs' entitlement to recover their embedded costs does not vary depending on whether the Commission adopts a 'market-based' or prescriptive approach"); Fischer et al. at 8 (USTA) ("a revenue shortfall is also inevitable under the 'market-based approach' or any combination of the two approaches"); Schmalensee and Taylor at 11 (USTA) ("The ILECs must have an opportunity to recovery prudently-incurred costs regardless of the mechanism used to move rates to more competitive levels").

[52]E.g., BellSouth at 65; SWBT at 52.

[53]In this regard, the ILECs repeatedly misstate the legal standard. See, e.g., BellSouth at 42 ("any approach adopted by the Commission to reform access charges -- prescriptive or not -- must permit LECs to recover all of their costs"); accord Pacific at 32-33, 44; U S WEST at 7, 78; GTE at 79.

[54]It would be the height of arbitrariness for the Commission to accept the ILECs' claims for billions of (continued...)

Commission has previously found that the TELRIC pricing methodology meets the constitutional standard.[55]

Indeed, all of the available evidence suggests that the ILECs are in an extremely strong financial position.[56] Notably, the ILECs have absorbed huge write-offs in recent years, and yet have remained very profitable. For example, as Pacific notes (at 46), "[i]n 1995 Pacific Bell discontinued use of SFAS 71 and recognized a one-time charge to our external financial reporting of $5.7B pre tax and $3.3 B after tax," and yet Pacific continues to prosper.[57] The LECs' high market-to-book ratios further underscore their strong financial position.[58]

Moreover, there is no merit to the ILECs' "regulatory compact" arguments. There was never any such "compact," but even if there were, it could not have survived the transition to price cap regulation. The ILECs' arguments on this score are thoroughly refuted in the attached forthcoming article written by William Baumol and Thomas Merrill.[59]

As to the second inquiry -- equity and fairness -- the ILECs' claims are equally meritless. First, equity requires the Commission to *balance* the interests of consumers and shareholders. There is substantial evidence that ILECs' shareholders' interests have been favored for far too

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[54](...continued)
dollars in subsidies. For example, GTE's unsupported claims that it will suffer $500 million in lost revenue cannot rationally be credited. <u>See</u> Vogel at 1 (GTE). GTE claims that it performed a "PXQ" analysis to derive this figure, but presents no supporting data, studies or work papers; indeed, it claims that "These revenue studies, as well as the associated cost information, is confidential and proprietary to GTE."

[55]*Local Competition Order* at ¶ 740 ("The just and reasonable standard of TELRIC plus a reasonable allocation of joint and common costs of providing network elements that we are adopting attempts to replicate, with respect to bottleneck monopoly elements, the rates that would be charged in a competitive market, and we believe is entirely consistent with the just compensation standard").

[56]AARP, CFA and Consumers Union at 6.

[57] <u>See</u> <u>also</u> MCI at 75 (write-off on financial books shows that LEC planned for the loss and was financially able to absorb the loss).

[58] Ad Hoc at 60 (market-to-book ratios).

[59] <u>See</u> Appendix E.

long.[60] But even a misguided focus on shareholders would not justify make-whole payments for the ILECs, because, as Time Warner points out (at 43), investors have long anticipated the onset of competition. And, as USTA effectively admits, any investment in plant and equipment after 1990 -- the year the price cap system was established -- must be disregarded.[61]

In all events, the ILECs' claims both overstate the downside of access reform and understate the upside. For example, ILECs will still be able to recover a substantial portion of the revenues that will be removed from price cap services through other mechanisms: universal service subsidies will be recovered directly from the USF, and the CCLC will be recovered from the end-user. On the upside, the ILECs have many opportunities to increase their revenues from other services.[62]

Moreover, the ILECs' claims that all of their embedded costs have been found prudent is false. Many states have adopted price cap regulation, and most states have gone years without conducting a LEC rate case.[63] And as Richard Lee shows (see Appendix D), the ILECs' claims

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[60]See AT&T Ex Parte Presentation, CC Docket No. 96-45, September 18, 1996 (showing that reinitialization of rate of return to 10 percent would have a $1.9 billion impact or $1.3 billion at 11.25 percent); Kravtin/Selwyn Reply; GSA at 14 ("There is ample evidence of high earnings by the Bell operating companies. The Commission's 492A Reports show 1995 returns ranging from 11.6 percent to 16.8 percent").

[61]USTA at 64 ("Once rates were set under price cap rules, beginning in 1991, the direct link to revenue requirements was broken"); see also Kravtin/Selwyn Reply, pp. 4-5 (64% of ILECs' historical book investment as of the end of 1996 can be attributed to plant installed in 1990 or later; 75% of digital switching plant acquired after 1/1/90).

[62]Kravtin/Selwyn Reply, pp. 12-18 (Appendix B); MCI at 4 n.9 (citing analysts for second line growth), 5 n.10 (Caller ID revenues for Bell Atlantic doubled in 1996); NCTA at 8 ("The high consumer demand for second lines and enhanced services such as call waiting, when combined with revenues ILECs can anticipate once they enter the interexchange market, significantly reduce the risk of under-recovery"); IXC Long Distance at 6; New York DPS at 3; Ad Hoc at 59.

ILEC claims that the Commission must confine its analysis along jurisdictional lines are clearly misplaced. Whatever force Smith v. Illinois 282 U.S. 133 (1930) might otherwise have, a fundamental purpose of the Telecommunications Act is to tear down these artificial jurisdictional lines. In any event, the old jurisdictional distinctions have never been applied beyond the context of assessing confiscation claims, and the Commission should surely disregard them for purposes of deciding whether forward-looking pricing is somehow "unfair." See Baumol-Merrill Article (Appendix D).

[63]See, e.g., Kansas Corporation Commission at 10 ("Southwestern Bell Telephone . . . has been

(continued...)

concerning underdepreciation are misleading and overstated. For all of these reasons, the Commission should reject the ILECs' overreaching embedded cost claims.

III. THE COMMENTS UNIFORMLY CONFIRM THAT THE RATE STRUCTURES FOR SWITCHED ACCESS SHOULD BE MODIFIED TO MAKE THEM MORE COST-CAUSATIVE.

Regardless whether the Commission adopts the market-based or prescriptive approach, it must reform the Part 69 rate structures for switched access so as to better reflect sound principles of cost-causation. The commenters confirm the Commission's finding (NPRM ¶ 6) that Part 69's inefficient rates structures have significant anticompetitive effects and are "fundamentally inconsistent with the competitive market conditions that the 1996 Act attempts to create."[64] Indeed, there is widespread recognition that the Act's procompetitive agenda *heightens* the need for cost-causative, efficient, nondiscriminatory rate structures. There is also a consensus that essential features of the switched access rate structure, including the carrier common line charge ("CCLC") and the transport interconnection charge ("TIC"), must be modified given the imperatives of the 1996 Act. The promise of the 1996 Act cannot be realized unless the Commission acts now to complete the work it began 14 years ago, namely, implementing efficient, cost-causative switched access rate structures.[65]

Predictably, several ILECs contend that the best means of promoting efficient rate design is to relieve them of the "artificial" rate structures mandated by the Part 69 rules and instead allow

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[63](...continued)
operating under an incentive rate making plan in Kansas since February, 1990, with no earnings sharing mechanism in place. In effect there has been no cap on regulated earnings. Thus 'rate case type proceedings' have not been held in Kansas . . ."); BellSouth at 46-47 (in BellSouth territory "all nine State commissions have adopted price [cap] regulation").

[64] See, e.g., Ameritech at 1-2; AT&T at 1-3, 49-51; Bell Atlantic/NYNEX at 1; BellSouth at 2; CBT at 1-2; GTE at 2, 17; CompTel at 2; Frontier at 1-2; MCI at 1; NCTA at 1; Sprint at 1-3; SWBT at 2.

[65] *Access Charge Order*, 93 FCC 2d at 275-76. The Commission again recognized the need for efficient, cost-based rates in its Section 251 Order in Docket 96-98. See *Local Competition Order*, ¶¶ 743-44.

each ILEC to develop what it deems to be an appropriate cost recovery mechanism.[66] These ILECs are wrong. Because market forces are insufficient to constrain the ILECs' pricing behavior, and with RBOC in-region entry into the interLATA market on the horizon, the incentives to discriminate are now greater than ever before. Therefore, it is *critical* that the Commission prescribe efficient, nondiscriminatory switched access rate structures and maintain them until effective competition in individual markets permits them to be removed. As the Commission has found, given the ILECs' significant market power in the provision of interstate access, rate structure rules that *discourage* unreasonable discrimination and its potentially adverse impact on competition should be given precedence over any benefits that might come from the ILECs' ability to depart from the Part 69 rules.[67] In all events, the flexibility to introduce new services with nonconforming rate structures, based on a public interest showing, gives ILECs substantial latitude to introduce access services featuring different pricing mechanisms.[68]

The remainder of this section describes the specific actions the Commission should take to create a more cost-causative rate structure for access.

A. The Carrier Common Line Charge Must Be Eliminated And The Subscriber Line Charge Cap Removed To Allow Full Recovery Of NTS Loop Costs From The Subscriber.

First, the comments confirm that the CCLC must be eliminated, and the current cap on the SLC removed. As the Commission found in the Access Charge Order, recovering nontraffic-sensitive ("NTS") costs through flat monthly charges imposed on end users would promote optimal utilization of telecommunications facilities,[69] and "it is important to move towards collecting these

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[66] See, e.g., BellSouth at 51, 67; SWBT at 12; Bell Atlantic/NYNEX at 39. See also CBT at 10; SNET at 37; USTA at 57 (all support flexibility for local switching rate structure).

[67] Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd. 6786, 6826 (¶ 325) (1990) *("LEC Price Cap Order")*.

[68] Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Third Report and Order, FCC 96-488, released December 24, 1996, ¶¶ 309-310.

[69] *Access Charge Order*, 97 FCC 2d at 242, 279; NPRM ¶ 58.

costs *from customers rather than carriers* on a flat rather than usage sensitive basis."[70] The comments support this finding and, in large measure, advocate the need to allow flat-rate subscriber line charges ("SLCs") to fully recover the costs of the loop from end users.[71]

The comments demonstrate that the CCLC charged to IXCs for recovery of loop costs violates economic cost-causation principles because the loop cost is not an incremental cost of providing access to carriers.[72] As Sprint (at 11) explains,

> "[t]he loop is necessary to connect the end user to the network, regardless of whether or what kind of calls the user places or receives. Even if the user does not make any telephone calls at all, he or she has chosen to be connected to the network so as to be in a position to receive calls, and should be expected to pay (except in high cost areas or low income situations that should be covered by universal service support) the cost associated with the decision to connect to the network."

Similarly, Frontier (at 5) correctly observes that IXCs do not cause loop costs; the costs of the loop do not vary with usage; LECs supply the loop to provide telephone service.

Given these characteristics of the loop, the Commission has correctly recognized (NPRM ¶ 58) that the CCLC is inherently inefficient and sends incorrect signals both to end users and IXCs because it is *not* assessed directly on the "cost causing" purchaser of the subscriber line. Indeed, it was for that reason that Chairman Hundt in 1995 acknowledged that "[w]e need ways to let the subscriber line charge caps approximate economically rational pricing for consumers and single line businesses," and that "we shouldn't be concerned about nickel and dime differences on the local telephone bill at the expense of having rational pricing."[73]

The comments exhibit widespread agreement that the economically correct solution is to eliminate the CCLC and charge the end user for the costs of the loop by eliminating the current cap

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[70] *Access Charge Order*, 97 FCC 2d at 265 (emphasis added).

[71] Because the Commission has capped SLCs, the remainder of NTS loop costs today are recovered from IXCs through the CCLC.

[72] See, e.g., Sprint at 11; WorldCom at 29; AT&T at 51.

[73] Address of Reed Hundt, Chairman, FCC, to Fall Business Conference, Competitive Telecommunications Association, October 10, 1995, quoted by Pacific at 60.

on the SLC.[74] Indeed, several parties confirm that the subscriber should pay on a flat-rate basis, not only for the cost of the outside loop plant, but also the NTS costs of the associated line card (i.e., the loop termination at the local switch),[75] and any retail marketing expenses that are currently included in access charges.[76]

Although the NPRM (¶ 65) proposes to eliminate the SLC cap for multiline business customers and residential lines beyond the primary line, that proposal, as various commenters show, is plainly insufficient to achieve a cost-based rate structure.[77] As SWBT (at 37) explains, "[i]t is faulty logic to allow efficient recovery of common line costs from large business users and non-primary residential users, but to force continued -- and acknowledged -- inefficient and insufficient recovery from all other customers." Accordingly, the SLC cap should be removed for *all* lines. Not only is this the economically efficient solution, as Chairman Hundt acknowledged in 1995, but there is no public interest reason to retain the cap. Quite the contrary, the Commission has already correctly concluded that "the implementation of the SLCs has produced significant benefits, leading to lower interstate toll rates and increased economic efficiency. SLCs have also reduced the untargeted support flows between high and low volume toll users."[78] The Commission should allow the efficiency-enhancing benefits of the SLC to be fully realized, by allowing the SLC to recover all NTS interstate costs.[79]

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[74] See Bell Atlantic/NYNEX at 33; BellSouth at 55; CBT at 9; GTE at 26-27; Pacific at 6, 59; SWBT at 7-8, 13, 38; U S WEST at 54; AT&T at 52; Frontier at 6; Sprint at 11; WorldCom at 29, 30-33.

[75] See AT&T at 53; Sprint at 18; WorldCom at 38; SWBT at 7-8, 13, 38. In both the NPRM (¶ 71) and the *Access Charge Order*, 97 FCC 2d at 269, the Commission, like the parties cited here, recognized that the interface between the subscriber line and the local switch is a nontraffic-sensitive dedicated facility.

[76] See AT&T at 53; SWBT at 5-6 (recognizing the overallocation of retail marketing expense to access identified in the NPRM ¶ 249).

[77] See AT&T at 53; Frontier at 8; SWBT at 37.

[78] End User Common Line Charges, 10 FCC Rcd. 8565, 8573-74 (1995).

[79] AT&T showed (at 54 n.89) that, when adjusted for inflation, today's equivalent of the $3.50 SLC, first initiated in 1989, would be $4.55. Moreover, the actual level of the SLC would need to rise only
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By contrast, simply changing the usage-sensitive nature of the CCLC to a flat-rate presubscribed line charge assessed on IXCs, as the Commission proposes, would *not* eliminate the inefficiencies of the CCLC's implicit cross-subsidy.[80] Rather, as SWBT (at 35) indicates, "flat-rate charges to IXCs would perpetuate recovery of a substantial portion of loop costs from the wrong party, thus denying the economic reality that these costs are inextricably linked to end users and the network access provided to them by ILECs." Moreover, as Sprint (at 14-16) demonstrates, a flat-rate CCLC imposed only on IXCs would be discriminatory: other service providers, including LECs, wireless carriers, information service providers and resellers, that originate or terminate traffic over the loop, would not be assessed the charge and IXCs would thus be subsidizing their use. Equally important, a flat-rate charge would not ameliorate the price squeeze problem, because IXCs would still be required to pay a non-cost-based charge to their ILEC competitors -- a charge that does not represent a real cost to the ILEC when providing long distance service itself.[81] Indeed, for these reasons, the assessment of a flat-rate CCLC on IXCs is inconsistent with Section

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by modest amounts to achieve full cost recovery. See Frontier at 6; Pacific at 61; Sprint at 12; SWBT at 7-8, 13, 38. Accordingly, increasing the residential and single-line business SLC in some serving areas should *not* jeopardize subscribership. Indeed, for most customers, any SLC increase would be offset by LD toll price reductions. See GTE at 28; Sprint at 12; AT&T at 14, 54.

[80] See, e.g., AT&T Comments, filed January 31, 1994, at 14-18, and AT&T Petition for Reconsideration, filed June 5, 1995, at 7-9, in The NYNEX Telephone Companies Petition for Waiver - Transition Plan to Preserve Universal Service in a Competitive Environment, 10 FCC Rcd. 7445 (1995); AT&T Comments, filed May 16, 1995, at 28-35, in Ameritech Operating Companies (Petition for a Declaratory Ruling and Related Waivers to Establish a New Regulatory Model for the Ameritech Region), 11 FCC Rcd. 14028 (1996).

[81] Although AT&T strongly opposes *any* continued assessment of the CCLC on IXCs, it agrees with CompTel (at 29), MCI (at 77), Sprint (at 14-16), and WorldCom (at 33-38) that a CCLC assessed as a per-presubscribed line charge is more cost-causative than bulk billing of the CCLC based on an IXC's relative minutes-of-use, which retains the current inefficient usage-sensitive recovery of NTS costs. In addition, bulk billing of the CCLC based on an IXC's historical share of either minutes or revenues would penalize IXCs that are losing market share and provide a windfall to entrants whose share is rapidly growing. See ALTS at 24-25; Sprint at 14; Teleport at 27.

254(b)(4) of the 1996 Act, which requires "equitable and nondiscriminatory contribution to universal service" by *all* telecommunications providers. AT&T at 54-55; Sprint at 13.[82]

B. The Comments Confirm That The Rate Structure For Local Switching Should Include Port Charges And Usage-Sensitive Charges.

The comments also confirm that a combination of a flat-rate and usage charges would best reflect the way costs for local switching are incurred, and would therefore be reasonable. In general, the comments support carrier payment of usage charges for the switching matrix and for trunk ports that terminate common transport, with flat-rate charges for trunk ports that terminate dedicated transport.[83] Additionally, as noted above, each line card that terminates a subscriber loop at the local switch is dedicated to a particular user and represents an NTS cost, which, like with the loop, should properly be charged to the subscriber via the SLC. AT&T at 55; Sprint at 18; WorldCom at 38; SWBT at 13-14.

The Commission should not, however, adopt a separate call set-up charge, as several ILECs suggest.[84] As AT&T previously showed (at 56), a separate set-up element is unnecessary given that many call set-up costs are now allocated to signaling, and the proposed rate structure for signaling includes signaling message charges for all calls.[85] Moreover, the Commission did not

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[82] If, notwithstanding these legal and economic deficiencies, the Commission nonetheless decides to impose a flat-rate presubscribed line-based CCLC, it must allow IXCs to pass through the charge to the end user by forbearing from the rate averaging requirements of Section 254(g). Sprint at 14-16; WorldCom at 33-38. This will at least permit nationwide IXCs to avoid, in part, the inefficiencies and competitive disadvantages inherent in having to average disparate end user costs when competing against predominantly regional IXCs.

Nevertheless, this is at best an imperfect solution. Stand-alone IXCs will have to pass on the flat-rate CCL charge to customers, whereas a carrier providing both local and long distance service (such as an RBOC) may be able to absorb the charge to gain market share.

[83] See ALTS at 26; AT&T at 55-56; CompTel at 30-31; MCI at 80-82; Teleport at 21; Ameritech at 14-15; BellSouth at 70; Pacific at 66; SWBT at 13-14; *Local Competition Order*, ¶ 810.

[84] See Ameritech at 15; Bell Atlantic/NYNEX at 39; BellSouth at 71; Pacific at 67-68; SWBT at 14; U S WEST at 57. See also USTA at 57; California at 6.

[85] If the Commission decides to adopt a call set-up charge for local switching, it must increase the productivity factor in the price cap formula. This is because, in recent years, the growth in messages

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require a call set-up charge as part of the rate structure for the unbundled local switching rate element nor, as CompTel (at 31) points out, has any state PUC. Thus, for consistency, a call set-up charge should not be part of the mandatory local switching rate structure.[86] And, as Sprint (at 19) notes, call set-up costs may be too small to warrant a separate rate element.

There is also general agreement that the Commission should *not* allow peak/off-peak pricing for local switching. As Ameritech (at 16) explains, local switching costs are not time-of-day sensitive. For that reason, as Bell Atlantic/NYNEX (at 40) note, peak/off-peak pricing could provide false market signals. But even if such variations existed and a price structure could be constructed to reflect the incremental costs of adding traffic at peak hours, as AT&T (at 56-57), MCI (at 83), Sprint (at 19-20), and SWBT (at 63) show, peak/off-peak pricing would add an altogether unnecessary level of complexity and be impractical to implement for both LECs and IXCs. For these reasons, peak-load pricing should be avoided.

C. The Commission Should Eliminate The Transport Interconnection Charge, Adopt A Bifurcated Rate Structure For Tandem-Switched Transport, and Retain the Current Structure For Direct-Trunked Transport and Entrance Facilities.

The comments likewise confirm that the TIC -- a non-cost-based, non-facilities-based, usage-sensitive charge assessed on all switched access minutes and accounting for 70 percent of the ILECs' transport revenues (NPRM ¶¶ 7, 43-44, 82, 96-97) -- must be eliminated immediately, for four independent reasons.

First, as WorldCom (at 65) explains, the current per-minute TIC raises long distance rates above economic levels and restricts long distance usage, to the serious detriment of consumers. This alone would justify eliminating the TIC as unjust and unreasonable.

Second, in any event, the 1996 Act requires the Commission to remove all implicit subsidies from access, and to price access at TELRIC. Accordingly, using this measurement, all facilities-

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has significantly exceeded the growth in minutes. Thus, absent this adjustment, price cap LECs can achieve higher revenues simply by charging for access based on their message volumes than by billing based on minutes of use.

[86] *Local Competition Order*, ¶ 810.

related costs currently recovered via the TIC will be recovered from the access rate elements set at economic cost, and the TIC will become unnecessary. MCI at 86; AT&T at 58-59.

Third, as Sprint (at 29-30) and Teleport (at 14 n.8) explain, the TIC is anticompetitive and inconsistent with the Act's competitive goals because it allows ILECs guaranteed recovery of their transport "costs" even when their networks are not used. Indeed, as AT&T showed (at 58), if the TIC recovers costs that are more appropriately recovered by transport facility charges, it distorts competition because it allows ILECs to price their transport facilities below cost and thus below the prices charged by transport competitors.[87]

Fourth, the Court of Appeals has admonished the Commission to "move expeditiously . . . to a cost-based alternative to the RIC, or to provide a reasoned explanation of why a departure from cost-based ratemaking is necessary . . . ." Competitive Telecommunications Association v. FCC, 87 F.3d 522, 532 (D.C. Cir. 1996) ("*CompTel v. FCC*"). No such justification exists here. The Commission has recognized that pricing of access at forward-looking economic cost best furthers efficiency (*Access Charge Order*, 97 FCC 2d at 251; NPRM ¶ 222), the industry has had 13 years for transitioning to cost-based transport rates (*CompTel v. FCC*, 87 F.3d at 530), and the new USF will supply any necessary subsidies (some of which may be recovered through the TIC today).

Nonetheless, and as expected, the ILECs all argue for maintaining TIC revenue streams for a period of years.[88] However, as demonstrated in Section II above, there is no sound legal or equitable basis for continuing this amorphous subsidy to the ILECs' bottom line.[89]

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[87] ILECs are able to do that because the TIC is applied to all minutes at the local switch, regardless of whose transport facilities the IXC uses.

[88] Ameritech at 22; Bell Atlantic/NYNEX at 38; BellSouth at 74-75; CBT at 10-12; GTE at 37; Pacific at 6, 73; SNET at 39-40; SWBT at 16; U S WEST at 63-64; USTA at 58-66.

[89] In all events, if the Commission were to allow some interim TIC recovery, it must adopt a competitively neutral recovery mechanism such as the retail end user surcharge which was broadly supported as the fairest means of subsidy recovery in the USF proceeding. See Comments, filed December 19, 1996, in CC Docket No. 96-45, by Ameritech at 30-31; AT&T at 6-9; Bell Atlantic at 8-9; BellSouth at 16; California at 13; MFS at 12; NYNEX at 23; USTA at 22; U S WEST at 45-46.

(continued...)

With the elimination of the TIC, there is generally little controversy that the transport rate structure should consist of charges for: (1) entrance facilities, (2) direct-trunked transport, and (3) tandem-switched transport.[90] Flat-rate charges for entrance facilities and direct-trunked transport, which were implemented at the end of 1993 with the restructure of local transport, reflect the way in which costs are incurred because the facilities used to provision these services are dedicated to a particular carrier. Id.

AT&T agrees with the ILECs that the Commission should *not* require ILECs to continue offering the unitary end office-to-serving wire center option for tandem-switched transport.[91] The ILEC comments confirm that the bifurcated structure is consistent with the way costs are incurred and would provide the proper incentives for carriers to order access efficiently.[92] As Bell Atlantic/NYNEX (at 41) point out, "[u]nder the current structure . . . LECs have been forced to provision the service less efficiently than they could if it were priced on an economically more rational basis. LECs have been required to maintain trunk capacity that is underutilized . . . . " Moreover, with pricing at TELRIC-based levels, the original concerns about rate shock that led to the unitary structure should no longer be a factor.

(...continued)
As shown in Section III.A (n.81) above, bulk billing schemes are not competitively neutral and have distortional effects.

[90] See e.g., Ameritech at 17-18; Bell Atlantic/NYNEX at 40-41; BellSouth at 71-72; NPRM ¶ 86. ILEC proposals to differentiate their services by various criteria, such as whether the IXC or ILEC has facility assignment control, should be justified on the basis of TELRIC support.

[91] See Bell Atlantic/NYNEX at 41; BellSouth at 73; GTE at 37-38; Pacific at 70; SNET at 38; SWBT at 14, 64; U S WEST at 59; USTA at 60; see also ALTS at 25; Teleport at 12-16.

[92] By ignoring the separate and distinct components of tandem-switched transport, the bundled, unitary structure fails to promote either efficiency or the possibility of competition for the individual components of tandem-switched transport. See ALTS at 25; Teleport at 13-14. Because interoffice facilities from the IXC's serving wire center to the access tandem are dedicated to the IXC's own use, fixed monthly charges should apply, reflecting the way these costs are incurred. This will provide appropriate incentives for IXCs to order facilities so as to achieve optimal loading of their traffic. Conversely, the use of facilities from the access tandem to the end office should be priced on a per-minute basis, as these facilities are used in common with other traffic handled by the LEC.

The Commission should also reject arguments by CompTel (at 25-26), MCI (at 86) and Sprint (at 21-25) that the Commission should retain the unitary per-minute end office-to-serving wire center rate structure for tandem-switched transport. Principles of cost-causation also require that mileage-sensitive rates be based, not only on overall mileage, but on the mileage of each specific link ordered by the customer. Teleport at 13-14. Cost-based mileage charges would encourage carriers to order facilities in a manner that minimizes routing distances, as well as to place their POPs in the most efficient locations.[93]

Likewise, the comments confirm that the tandem switching charge must be cost-based to avoid the distortions and inefficiencies uneconomic prices invariably create. As with the pricing of local switching, a flat-rated charge for the dedicated ports on the SWC side of the tandem switch would be reasonable (Ameritech at 20; Pacific at 69; AT&T at 60; Teleport at 19-20), and peak/off-peak pricing should not be adopted. CompTel at 27-28; AT&T at 60; Teleport at 21.

D. The Commission Should Adopt Its Proposed Unbundled Rate Structure For SS7 Signaling.

The comments also confirm that the Commission should adopt its proposed unbundled rate structure for SS7 signaling. Although the proposed unbundled rate structure modeled after the structure permitted in the Ameritech waiver (see NPRM ¶ 127) is generally supported as cost-causative, a number of parties identified lack of measurement capabilities as an obstacle to its current implementation.[94] Accordingly, the Commission could adopt the structure but delay its implementation. At a minimum, however, the Commission should include the STP port termination

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[93] Contrary to Sprint's suggestion (at 23), ILECs would not be likely to locate tandems far away from IXC POPs in order to assess greater mileage charges, because only a small fraction of the traffic utilizing tandem switches is interstate transport.

Nevertheless, although the bifurcated structure is clearly preferable for these and all the reasons demonstrated in Docket 91-213, AT&T does not believe that the Commission should prohibit the LECs from offering an optional unitary structure *so long as* the rates for the unitary service option reflect the full TELRIC costs of providing the option and do not burden other users with its costs. See AT&T's Reply Comments, filed March 19, 1993, in Transport Rate Structure and Pricing, CC Docket No. 91-213, at 12-13.

[94] Bell Atlantic/NYNEX at 40; BellSouth at 81; Pacific at 71; SNET at 40; SWBT at 15; U S WEST at 73.

charge in the traffic-sensitive basket and leave the unbundled link in the trunking basket to ensure that ILECs will not be able to respond to competitive pressures in their signal link business by simply raising the level of the STP port charge. NPRM ¶ 130; AT&T at 64 n.104; MCI at 87-88.

IV. THE COMMENTS DEMONSTRATE THAT THE PRICE CAP RULES MUST BE MODIFIED TO COMPLY WITH THE ACT'S REQUIREMENTS.

As AT&T demonstrated in its opening comments, certain adjustments must also be made to the price cap system to make it consistent with a cost-based approach, regardless whether the Commission adopts a "market-based" or "prescriptive" approach to access charges generally. See AT&T at 63-71.

A. All Cross-Subsidies Should Be Removed From Price Caps, Including Equal Access Expenses.

For example, as AT&T explained, all cross-subsidies, including both explicit ones, such as universal service subsidies, and implicit ones, such as retail expenses and expenses of general support facilities that support nonregulated billing and collection services, should be removed from price caps. The comments reveal broad support for these propositions.[95]

Some ILECs nevertheless argue that they should not have to make a downward exogenous adjustment to reflect the fact that their equal access network reconfiguration costs have been fully amortized.[96] Notably, these ILECs do not dispute the merits of such an adjustment; instead they claim that the issue has already been litigated and settled. This is not true, however, as the Commission (NPRM at ¶ 292) makes clear. Neither the 1994 access tariff proceeding nor the LEC Price Cap Performance Review produced a definitive, substantive finding on the issue. The Commission should now require the adjustment, especially in light of the Commission's previous finding that the failure to make such an adjustment would be unfair to ratepayers and would perpetuate an implicit cross-subsidy in the LECs' favor. See AT&T at 68-69 and App. F.

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[95]Ameritech at 8; SWBT at 6; Sprint at 4; New York DPS at 3; NCTA at 28; PCIA at 3.

[96]See, e.g., USTA at 85; SWBT at 59; Ameritech at 54.

B. The X-Factor Must Be Increased To Ensure That Access Charges Remain Just And Reasonable.

As AT&T has also shown, both here and in the context of the Fourth Further Notice of Proposed Rulemaking in Docket No. 94-1, the current X-Factor substantially understates the ILECs' true rate of productivity growth. If the X-Factor is allowed to remain at its present level, price cap levels will become increasingly inaccurate and will confer an increasing windfall on the ILECs, even if the caps are reintialized and set at cost. The comments broadly support these conclusions.[97] Therefore, the Commission should adopt a minimum X-Factor of 9.0 percent, including a CPD of 0.5 percent.[98]

The ILECs, however, argue that both competition and access reform itself will *decrease* productivity growth.[99] This is incorrect for several reasons. First, until competition arrives, reinitializing the price caps to cost-based levels will clearly stimulate demand for access services and thereby lead to higher calling volumes and higher productivity. Moreover, contrary to the ILECs' arguments, true competition -- when and if it arrives -- will only reinforce this trend. Indeed, Congress fully expected that the introduction of competition would result in a larger economic pie to be divided between the competing firms; it did not enact the 1996 Act on the premise that productivity would be reduced.

Second, access reform should not decrease the ILECs' productivity growth. Again, to the extent that access reform results in cost-based rates, that should *increase* productivity growth by sending correct economic signals to all market participants. In addition, the ILECs' arguments assume that the Commission will adopt their uneconomic reform proposals, such as converting the CCLC into a flat-rate charge assessed on IXCs. On the contrary, the Commission should eliminate

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[97]See, e.g., MCI at 25-26 (citing studies supporting higher X-Factor and advocating increase in X-Factor); Ad Hoc at 70. See also CARE Coalition Ex Parte Comments, CC Docket No. 94-1 (April 16, 1996).

[98]See Appendix H (Statement of John R. Norsworthy, which updates AT&T's Docket 94-1 X-Factor submissions to reflect 1995 productivity data).

[99]See, e.g., USTA at 18-19; SWBT at 58-59; Pacific at 40; Bell Atlantic/NYNEX at 58-59; U S WEST at 46-48.

the CCLC altogether and remove subscriber lines from price caps. These measures would result in price capped revenues derived solely from switching, transport and signaling, which are characterized by higher productivity growth. Thus, neither competition nor access reform would justify a lower X-Factor than the one AT&T has already proposed in Docket 94-1.[100]

Finally, there is no merit to criticisms by USTA's expert of AT&T's Performance-Based Model for calculating total factor productivity.[101] As Dr. Norsworthy shows in the attached statement, these criticisms are unfounded.[102]

V. THERE IS WIDESPREAD AGREEMENT THAT INCREASED REGULATORY FLEXIBILITY PRIOR TO THE EMERGENCE OF PRICE-CONSTRAINING COMPETITION WOULD BE UNLAWFUL.

Putting aside the anomalous and wholly unjustifiable position of GTE, the commenters unanimously agree that regulation of exchange access is appropriate under current market conditions. And they all recognize the need to eliminate significant entry barriers -- both legal and economic -- prior to granting price cap LECs increased regulatory flexibility. At this point, however, the ILECs diverge from the vast majority of the commenters[103] by advocating indefensibly lenient requirements for partial and even total deregulation of exchange access services. In so doing, they ignore persistent, substantial barriers to entry and the more than sufficient pricing flexibility they already possess. Consequently, the deregulatory measures proposed by the Commission and the ILECs would "raise[] substantial risks for competition and consumer benefit." Kwoka at 2 (MCI).

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[100]Indeed, because access reform and the resulting cost-based rates should be expected to increase productivity, the Commission would be fully justified in retaining the consumer productivity dividend.

[101]See USTA at 18-22 and Christensen Associates, "Critique of the AT&T Performance-Based Model" (Attachment 6).

[102] See Statement of Dr. John R. Norsworthy, "Response to Christensen's 'Critique of AT&T Performance-Based Model' and to Strategic Policy Research's 'The Depreciation Shortfall,'" (Appendix H).

[103]See e.g., AARP, CFA, and Consumers Union at 7-9; ICG at 9-10; Wash. UTC at 7-8.

A. The ILECs Have Utterly Failed To Demonstrate That Further Increases In Pricing Flexibility Are Necessary Or Desirable.

As a threshold matter, there is no need for increased pricing flexibility. Local monopolists are not being unjustly harmed when they lose a customer; rather, if competition develops as they have alleged it will, then they should expect to lose many customers. Contrary to ILEC claims that they must have *enhanced* flexibility at the mere appearance of potential competition,[104] current price cap flexibilities are adequate.

As Time Warner correctly points out (at 26), "[l]ower price bands have now been eliminated, and ILECs have a limited ability to offset price decreases for services" by increasing the price of services in the same basket. Moreover, as MCI demonstrates (at 48), the ILECs have "failed to utilize their existing pricing flexibility" even in markets where there is "nascent competition." Given that new entrants will typically attract new customers by offering lower prices and incumbents already have authority to lower their currently excessive rates, the Commission should not even entertain a request for further relaxation of the price cap rules.

The ILECs also contend that increased regulatory flexibility is necessary so that the incumbent and entrants will be regulated "as symmetrically as possible. . . ." Schmalensee and Taylor at 24 (USTA).[105] This argument, however, presupposes that once some measures are taken to restrict incumbent pricing behavior, the incumbent and the entrants will be on an even playing field in all other respects. Plainly, that will not be the case. As discussed above in Section II, many legal and economic barriers persist, and "asymmetric" regulation will be justified as long as that remains true.

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[104] See Bell Atlantic/NYNEX at 45.

[105] Schmalensee and Taylor (at 23) also cite the banking and freight industries as examples of industries where unnecessary regulation created "significant societal costs." They do not, however, explain the relevance of their observations on those industries to exchange and exchange access markets, in which a vertically integrated monopolist that controls bottleneck facilities will be the primary and often sole provider of inputs to its direct competitors. Also, those industries were regulated in a totally different fashion that did not provide the extensive flexibility inherent in price cap regulation.

B. Many Commenters Agree That Granting The ILECs Increased Regulatory Flexibility Without A Clear Demonstration Of Price Constraining Competition Would Be An Arbitrary And Capricious Reversal Of Past Commission Practice.

Moreover, as AT&T demonstrated (at 76), the Commission has historically required a clear showing that competitive pressures are sufficient to constrain a dominant firm's market power before granting further pricing flexibility. Most notably, the Commission developed a comprehensive record to support deregulation of AT&T. See Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier, 11 FCC Rcd. 3271 (1995). Because "[t]he ability to price discriminate and to target selectively competitive markets" creates a tremendous impediment to entry, AT&T was not extended the necessary flexibility to engage in such potentially dangerous price behavior "until after competitors were firmly established in 1989." ICG Telecom at 14. For example, volume and term discounts, contract tariffs, and to some extent, geographic deaveraging, required a demonstration of substantial competition. See, e.g., Time Warner at 30-33. And as TCG (at 34) forcefully observes, "the very first order implementing any form of Title II deregulation of [AT&T] was released nine years after the [MFJ]" during which time "the Commission continually reviewed the competitiveness of the long distance market" and refused to relax price cap regulation of AT&T despite the fact that multiple facilities-based competitors were in the market and winning substantial market share in all segments of the long distance market.

Indeed, the AT&T framework for deregulation may not be stringent enough in this context. First, AT&T was not a multi-product firm that supplied its competitors with one or more essential inputs. "Second, the economic costs of premature deregulation are far greater in the case of the incumbent LECs than for a company without bottleneck control of any service." MCI at 67. As shown below, the ILECs' control over bottleneck inputs creates an opportunity for ILECs to maintain their stranglehold on local markets and potentially leverage their monopoly position into interexchange services. In short, it would be arbitrary for the Commission to adopt a *less* stringent approach in granting new pricing flexibility to the ILECs than the Commission adopted for AT&T.

C. The Commenters Generally Agree That The Additional Pricing Flexibility Proposals In The NPRM Would Be Anticompetitive And Discriminatory.

Except for the ILECs themselves, few commenters dispute the ability of incumbents to engage in anticompetitive behavior. Alabama PSC at 13; Texas OPC at 45; ACC Long Distance at 5. Indeed, the capacity for discriminatory and anticompetitive conduct is inherent in an incumbent's control over the local network. This control permits an incumbent to do such things as "degrading the quality of access or network services," providing ILEC affiliates with improvements and advances before other competitors, and "delaying offering new technical input configurations to downstream competitors until [the ILEC's] own affiliates are prepared to make the change," to name a few. Time Warner at 38-39. See also Kwoka at 7, 11 (MCI). This problem is particularly acute given that "for the foreseeable future, competitive exchange access providers will remain dependent upon the incumbent LEC to reach most, if not all, of the competitors' customers." ICG Telecom at 12.[106]

It is also very likely that premature regulatory flexibility will exacerbate anticompetitive behavior. "Once a Bell Operating Company is allowed to provide interLATA services, its incentives to provide and implement workable interconnection arrangements with competitors will largely disappear." WinStar at 7. Time Warner correctly recognizes (at 24-25) that any degree of deregulation amounts to permitting the ILECs to "eat the carrot" and "effectively withhold cooperation. . . ."[107] Moreover, "[e]ven facilities-based competitors would remain vulnerable to

[106] The ILECs have already demonstrated their potential for anticompetitive conduct. For example, they have "vigorously" opposed the provision of local exchange service through the "[recombination of] unbundled network elements. . . ." ACC Long Distance at 5. In addition, ICG (at 9) has alleged that "many ILECs simply rely on the tariffed rates, terms and conditions still under investigation and will not further negotiate collocation rates despite passage of the Act." Similarly, the SDN Users note (at 2) that "[w]hile it is true that some arenas have shown movement, most have seen resistance, slow action, and disingenuous behavior."

[107]The Commission embraced the same reasoning in Expanded Interconnection with Local Telephone Company Facilities, CC Docket No. 91-141, 9 FCC Rcd 5154, 5424 (1994): "If pricing flexibility were not related to the implementation and subsequent development of expanded interconnection, LECs might not have the incentive to act cooperatively . . ."

anticompetitive abuses by incumbent LECs . . . because they must interconnect with the incumbent LECs' networks." TRA at 13.

The three most dangerous anticompetitive price strategies, cross-subsidization, predation, and the price-squeeze, have received considerable attention in the comments. No commenter, however, has credibly demonstrated that these practices will not occur in the absence of continued price cap regulation.

As many commenters recognize, relaxation of price cap regulation would give the ILECs an increased ability to cross-subsidize competitive services with the excessive income earned on noncompetitive ones.[108] The NPRM's proposed pricing flexibility enhancements present particularly acute cross-subsidy opportunities so long as the price caps remain above cost. Most notably, the ILECs would not even have to raise prices for noncompetitive services in order to subsidize competitive ones because they are already earning monopoly rents on their exchange access services.[109]

The ILECs have not and cannot demonstrate that cross-subsidization will not persist. Rather they simply claim that price cap regulation reduces their ability and incentive to engage in this practice. See, e.g., Schmalensee and Taylor at 39 (USTA). This argument, however, merely highlights the need for continued price cap regulation absent price constraining competition. Granting ILECs further pricing flexibility will eviscerate the crucial protection the current rules now

[108]As LCI notes (at 15), if the Commission relaxed price cap regulation now, "the Commission would have handed the RBOCs a $10 billion windfall, straight from the pockets of their competitors, from which they can cross-subsidize their own long distance services, while depriving IXCs of badly-needed revenue to build competitive local services networks." See also California at 8; Time Warner at 37 (the elimination of "lower pricing bands has only increased the opportunity to cross-subsidize within a basket"); Tenn. Reg. Auth. at 4 ("Increases in access charges in less competitive areas could stifle inter-LATA competition and add pressure for deaveraging of rates to those areas").

[109]The only way to prevent cross-subsidization in the presence of supracompetitive access rates would be for the Commission to reinstitute its lower price cap bands and maintain price cap regulation until every service in every geographical area of an ILEC service territory has developed sustainable, price constraining competition. See Ad Hoc at 52. Clearly, this solution exceeds any measures the Commission is likely to implement. However, it dramatically illustrates not only the potential for cross-subsidization but the reality that cross-subsidization will continue even under the current regulatory rules.

provide, and open the door to further anticompetitive conduct and unnecessarily high consumer charges.

In addition, the ILECs and their experts misconceive the potential for predatory pricing by relying on the *Matsushita* criteria. See, e.g., Schmalensee and Taylor at 38 (USTA); U S WEST at 33. Most importantly, unlike the usual predation scenario, the incumbents in this market do not have to wait for a later period to recoup their profits. They can earn supracompetitive profits immediately by retaining the local customer and earning monopoly rents, particularly on terminating access.[110] Moreover, if entry occurs through the use of unbundled network elements -- which the ILECs have contended is sufficient to create price constraining competition -- such entry will not produce the new facilities that would make subsequent entry easier.[111]

Finally, the comments confirm that the ILECs' control over bottleneck inputs allows them to engage in an anticompetitive price squeeze. More specifically, an ILEC can "recover a disproportionate share of shared and common costs from those consumers who do not have competitive alternatives . . . and [impose] a price squeeze on competitors who have no ability to shift costs." ICG at 14. See generally Baumol/Ordover/Willig (Appendix A).

One price squeeze of particular concern affects IXCs. As discussed in Section II, regardless what effect UNE-based competition has on local exchange prices, it is unlikely to provide downward pressure on exchange access prices. Consequently, an incumbent carrier can charge these higher rates to its competitors in the long distance market while itself incurring only the

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110 "[I]n contrast to conventional predation scenarios, the firm does not have to wait until some uncertain future period to begin recouping its costs of anticompetitive actions. It should also be emphasized that concern over such strategic pricing rises with the degree of pricing flexibility granted under price caps." Kwoka at 8 (MCI). As demonstrated in Section II, terminating access will most likely remain immune to competitive forces into the foreseeable future and reward the incumbent with supracompetitive profits. See also Baumol/Ordover/Willig (Appendix A).

111 The ILECs have based their arguments against the potential for predatory pricing in part on the claim that "[r]ecoupment is especially difficult in telecommunications because the underlying network of one's competitors remains in place after predation because of the sunk-cost characteristics of such facilities." Schmalensee and Taylor at 22 (USTA). However, given that entrants are far more likely to initially rely on unbundled network elements, they will not have incurred these sunk costs, which might otherwise discourage predatory pricing by the incumbents.

economic cost of exchange access. Faced with these inflated input prices, IXCs will not be able to compete with the incumbent. Baumol/Ordover/Willig at Section II. Contrary to the claims of Schmalensee and Taylor (at 41-42) (USTA), such a strategy does not depend on increased demand for long distance calls or narrowly defined long distance market share. Id. Not only does this scheme perpetuate excessive long distance fees, it also inhibits competition in long distance markets.

With this background, the remainder of this section explains why each of the specific "flexibility" proposals contained in the NPRM would be counterproductive and, indeed, unlawful.

1. **Geographic Deaveraging.** The commenters uniformly agree that deaveraging of exchange access rates "will slow and distort actual competition in some markets and not benefit consumers in other markets at all."[112] As a fundamental matter, no deaveraging should be permitted unless it is cost-based. State commissions have declined to deaverage access-related UNEs because their costs do not depend on the area in which they are employed.[113] Accordingly, unless the states find a cost-based justification for deaveraging, the Commission should not permit any further deaveraging of equivalent exchange access elements.

Permitting ILECs to deaverage access rates would allow ILECs to engage in cross-subsidization of high density zones by increasing the rates in low-density zones. As the State Consumer Advocates point out (at 43), "The danger of deaveraging, whether geographic or otherwise, is that this deaveraging will most likely be used by the LECs to extract a higher contribution in those areas where they have little competition (i.e., monopoly power) than the contribution they may obtain from those areas where they face competition."[114] "[I]f left to LEC

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[112] Kwoka at 20 (MCI); see, e.g., ICG at 14 ("Geographic deaveraging before there is full competition and competitors can serve all parts of the ILEC's service area raises similar concerns.").

[113] See also MCI at 57 ("[T]here is no cost basis for geographic deaveraging of switched rates.").

[114] See MCI at 57 ("The essential problem with geographic deaveraging is that it would allow an incumbent LEC to lower access charges in only those markets where it faced competitive entry. This would handicap entrants and rivals there, without jeopardizing LEC profit elsewhere -- and may even induce the LECs to raise charges in other markets.").

discretion, price flexibility will predictably result in reductions designed primarily to deter competition."[115]

2. Volume and Term Discounts. The comments also support AT&T's position that additional volume and term discounts[116] should not be allowed until actual competition develops.[117] As MCI points out, term and volume discounts "explicitly allow selective price reductions to forestall competition, rather than to foster it [and] do not confer any benefit to customers in other markets and circumstances."[118]

The Commission has identified certain limited circumstances where such discounts are cost justified. In all other cases the discounts will not be cost justified,[119] and thus allowing the ILEC to offer such discounts will permit the ILEC to cross-subsidize from non-competitive areas.[120] Term discounts also allow an ILEC to lock in long-term customers at its current rates.[121] These long-term contracts will prevent those customers from realizing the benefits -- in the form of lower prices -- of future competition and, by removing desirable large-volume customers from the market,

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[115]See Kwoka at 20 (MCI).

[116]AT&T also supports the Commission's conclusion, NPRM ¶192, that it is not in the public interest to allow the ILECs to provide growth discounts. The Commission is correct that these discounts are not cost-justified and would allow ILECs to circumvent the nondiscrimination provisions of Section 272. Id.; see Kwoka at 20-21 (MCI).

[117]If the Commission does decide to allow additional term and volume discounts, "[a]t a minimum, the Commission should require incumbent local exchange carriers rigorously to cost-justify any [volume or term discount] proposal -- in addition to making the competitive check-list showing." Frontier at 15.

[118]Kwoka at 20 (MCI).

[119]See MCI at 58 ("there is no evidence that there is a cost basis for volume discounts for access services other than transport. . . . Volume discounts would simply be a mechanism for the incumbent LEC to discriminate between different classes of access customers."); see also ACTA at 18 ("Volume discounts, by their very nature, are discriminatory.").

[120]See Tele-Communications, Inc. at 28.

[121]See Comp. Policy Inst. at 28; MCI at 58; CompTel at 23. The comments of ACC Long Distance (at 8 n.14) provide an example where NYNEX used a term discount to undermine its entry in upstate New York.