

foreign firm engages in transfer pricing or not, the profits of the combined entity (foreign carrier and foreign-affiliate) will remain the same. There are no unfair advantages -- and no additional profits.

In addition to ESI's arguments, AT&T claims that a monopolist foreign carrier "may obtain three additional potential sources of profit on international traffic to and from its home country by establishing an affiliate carrier in the U.S. market."<sup>115/</sup> As demonstrated below, these additional sources of profit are either non-existent or are available to any carrier, foreign-affiliated or not, who enters the U.S. market.

AT&T's first claim is that "as the above-cost settlement rate likely exceeds U.S. termination costs, through such an affiliate the foreign carrier may earn profits from terminating U.S.-inbound traffic."<sup>116/</sup> A simple example showing the change in settlement revenues to a foreign carrier entering the U.S. market on a route to an affiliated country readily establishes that this is not the case. In Table 1A, traffic volume on the U.S.-Country X route is 100 minutes; on the return Country X-U.S. route, 50 minutes; and the settlement rate is \$1.00 per minute.

**Table 1A**

<b>BEFORE FOREIGN CARRIER ENTERS MARKET ON AFFILIATED ROUTE</b>			
<b>Carrier</b>	<b>Country X-U.S. Route</b>	<b>U.S.-Country X Route</b>	<b>Net Settlements Revenues (Payments)</b>
Carrier X	\$ -50.00	\$ 100.00	\$ 50.00
AT&T	\$ 50.00	\$ -100.00	\$ -50.00

In Table 1A, Carrier X receives net settlement revenues of \$50 because the traffic imbalance is 50 minutes.

<sup>115/</sup> Comments of AT&T 41.

<sup>116/</sup> Id.

Table 1B modifies the example to illustrate the entry of Affiliate X, 100% owned by Carrier X, on the U.S.-Country X market. It is assumed that Affiliate X is able to capture 20% of the market on the U.S.-Country X route, entitling it to 20% of the return traffic on the Country X-U.S. route. The last row of Table 1B establishes the corporate-wide position Corporate X based on the combined activity of Carrier X and Affiliate X.

**Table 1B**

<b>AFTER FOREIGN CARRIER ENTERS MARKET ON AFFILIATED ROUTE</b>			
<b>Carrier</b>	<b>Country X-U.S. Route</b>	<b>U.S.-Country X Route</b>	<b>Net Settlements Revenues (Payments)</b>
Carrier X	\$ -50.00	\$ 100.00	\$ 50.00
AT&T	\$ 40.00	\$ - 80.00	\$ -40.00
Affiliate X	\$ 10.00	\$ - 20.00	\$ -10.00
Corporate X	\$ 40.00	\$ 80.00	\$ 40.00

A comparison of Tables 1A and B demonstrates that the combined settlement revenues of Corporate X's Carrier X and its U.S. Affiliate X are actually **lower** (\$40.00) than if Affiliate X had not entered the U.S. market (\$50.00). Clearly, the foreign carrier seeking to maximize profits from above-cost settlement rates should not enter the U.S. market. This result should be intuitively obvious. No carrier is going to enjoy greater settlement revenues by entering the U.S. market as long as the United States continues to have settlement deficits.

AT&T's second claim is that "to the extent that its U.S. collection rate exceeds costs, the foreign carrier may use its affiliate to earn profits on U.S.-outbound traffic."<sup>117/</sup> AT&T is at once 100% right and 100% wrong. AT&T is right in that it pinpoints the key factor behind any (affiliated or unaffiliated) carrier's decision to enter

<sup>117/</sup> Id.

the U.S. market: the availability of high price-cost margins in U.S. IMTS markets, as demonstrated above in Part V.

AT&T is wrong, however, in implying that this is an anti-competitive practice. Rather, it is normal, competitive behavior for any carrier to enter new markets where there are substantial price-cost margins. Carriers affiliated with monopoly foreign carriers have no particular advantage, for they will earn only as much profit as every other carrier in that market (as long as the affiliate has the same settlement rate as required by the ISP). Thus unmasked, AT&T's concern here appears to be protecting its huge price-cost margins, which are likely to be reduced as more entrants make the market more competitive. While it may not be in AT&T's interest to face real competition which could reduce its exorbitant price-cost margins, it is in the public interest, for it means lower prices for U.S. consumers. In short, AT&T, by raising the illusory specter of anti-competitive practices by foreign carriers, is simply doing its best to protect its margins from competition.

AT&T's third claim is that "by using its affiliate to lower price in the U.S. market, the foreign carrier may earn additional settlements revenue by stimulating additional U.S.-outbound traffic to its home market from all carriers."<sup>118/</sup> This claim is premised on the further claim that although foreign carriers "may 'pay' themselves the same nominal settlement rate as U.S. carriers, this is merely an internal transfer payment."<sup>119/</sup> There are two fatal problems with AT&T's argument.

**First**, as demonstrated above in the example with Tables 1A and B, entering the market to an affiliated country and treating the settlement payment as "merely an internal transfer payment" **reduces** the total corporate settlement revenues on the route.

<sup>118/</sup> Id.

<sup>119/</sup> Id. at 43.

**Second**, if it were profitable for a foreign carrier to subsidize its affiliate, it would not need high settlement fees to do it, but could use its profits or borrow the funds necessary to do so. It would not, however, be profitable to cross-subsidize an affiliate to permit it to charge prices below incremental costs. In the words of GTE: "[a] foreign carrier has no incentive to squander its profits by cross-subsidizing a U.S. affiliate because it will never be able to recover, in the form of later monopoly profits, more than the losses suffered."<sup>120/</sup> There are several reasons for this. For one, it would violate the Communications Act to price below long run incremental costs.<sup>121/</sup> For another, most customers do not pick a carrier on the basis of one country pair route, but rather on the basis of a variety of routes. Furthermore, even in the unlikely event it were possible (and legal) for a foreign-affiliated carrier to gain a dominant market share by pricing below cost and driving AT&T and other U.S. carriers from the market, it would not be possible to earn monopoly profits by subsequently increasing prices because U.S. carriers such as AT&T could quickly re-enter the market. Thus, the "competitive conditions" necessary to make predatory behavior possible alluded to by AT&T simply do not exist.<sup>122/</sup>

Nevertheless, AT&T argues that the increased settlement payments resulting from increased outbound traffic volume will itself provide the incentive for foreign-affiliated carriers to reduce prices:

The additional profits to be obtained by foreign carriers from their above-cost accounting rates when U.S. price reductions stimulate increased U.S.-outbound traffic volumes are further demonstrated by recent price changes on the U.S.-U.K. route. Accordingly to AT&T's estimates,

<sup>120/</sup> Comments of GTE at 25 (citing Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 113 S. Ct. 2578, 2588 (1993) (citing Masushita Electric Industrial Co. v. Zenith Radio Corp., 475 U.S. 574, 588-89 (1986))).

<sup>121/</sup> 47 U.S.C. § 201(b).

<sup>122/</sup> Comments of AT&T at 43 n.69.

both MCI and AT&T will lose revenues from MCI's recent consumer price reduction to \$0.12 per minute on this route, which AT&T has also now introduced. However, BT, which terminates the large majority of U.S.-U.K. traffic, will earn additional revenues as a result of the increased settlement payments from the stimulated traffic volumes.<sup>123/</sup>

The focus of this complaint is not that foreign-affiliated carriers will price their services below cost, but that they will price their services below those of AT&T. Thus, "AT&T will lose revenues" -- which is another way of saying that competition will force prices, margins and profits down.

AT&T's argument loses sight of the fact that any carrier who enters a market characterized by excessive profits is likely to reduce rates in order to stimulate business and gain market share. This is how a market functions. MCI's behavior is pro-competitive, not anti-competitive. Indeed, it is a sign that the U.S.-U.K. route is, in fact, quite competitive. This is good news for consumers, who are paying lower prices for service. That AT&T does not view this a good news signals that it does not want to compete: it simply wants to maintain for as long as possible the excessively high margins that it currently enjoys. Instead of whining, AT&T should compete on both sides of the U.S.-U.K. a route with its U.K. affiliate, or strike a deal with another U.K. carrier under the auspices of the Commission's Flexibility Order.

#### **VIII. THE COMMISSION HAS NOT DEVELOPED A RECORD WHICH SUPPORTS IMPOSING MANDATORY BENCHMARKS**

This proceeding has not developed the necessary record to support imposing specific mandatory benchmarks on foreign carriers. The Commission relies on assumptions, not data, to approximate the costs of foreign carriers, and, as Cable &

<sup>123/</sup> Id. at 42.

Wireless points out, "the basis for these assumptions is quite questionable."<sup>124/</sup> Such an approach to what is essentially rate-making is unfair and could not withstand judicial review.

The imposition of mandatory benchmarks on foreign carriers is, in fact, rate-making. As C&W demonstrate in their comments, whether an agency's actions constitutes rate prescription is assessed by its effect, not by what the agency calls it.<sup>125/</sup> Mandatory benchmarks, purportedly based on cost and backed up by sanctions, are plainly prescribed settlement rates. Such rates must be justified by the record.<sup>126/</sup>

The record in this proceeding simply does not support the proposed benchmark rates. The NPRM itself concedes that it simply does not have -- and cannot get -- the information necessary to prescribe benchmarks based on foreign carriers' actual costs.<sup>127/</sup> Lacking cost data, the Commission resorts, not to a "reasonable surrogate,"<sup>128/</sup> but to "[p]ious hope and speculation [in the place] of evidence."<sup>129/</sup> Specifically, the Commission relies on a series of unsubstantiated assumptions and/or information. Much of this "data" is supplied entirely by AT&T, the party with the most to gain from this proceeding. The final result is that the proposed benchmarks bear no relationship whatsoever to the costs they are supposed to approximate.<sup>130/</sup>

<sup>124/</sup> Comments of Cable & Wireless at 15.

<sup>125/</sup> Id. at 16 (citing Nader v. FCC, 520 F.2d 182, 202 (D.C. Cir. 1975)).

<sup>126/</sup> Comments of Cable & Wireless at 15 (citing Nader v. FCC, 520 F.2d at 192-93)).

<sup>127/</sup> NPRM ¶¶ 33 & 41; International Bureau Study at 1.

<sup>128/</sup> Comments of AT&T at 27 (citing NARUC v. FCC, 737 F.2d 1095, 1140 (D.C. Cir. 1984)).

<sup>129/</sup> NARUC v. FCC, 737 F.2d 1095, 1140 (D.C. Cir. 1984) (citing Natural Resources Defense Council, Inc. v. EPA, 655 F.2d 318, 346 (D.C. Cir.) (Robb, J., dissenting), cert. denied, 454 U.S. 1017 (1981)), cert. denied, 469 U.S. 1227 (1985).

<sup>130/</sup> Comments of AT&T at 27.

A brief look at some of the more obvious weaknesses in the record demonstrate that there is absolutely no basis for the Commission to push ahead with its proposed benchmarks:

- The NPRM assumes that foreign carriers' tariffed prices can be used to approximate their actual costs -- even though the NPRM itself acknowledges that in many instances tariffed prices bear no relationship whatsoever to costs.<sup>131/</sup> This is particularly true with respect to national extension (the largest component of the benchmarks), which many countries deliberately price at below cost in order to increase access to the telephone network. Indeed, several countries price national extension at zero -- clearly well below the actual costs of the service.<sup>132/</sup> The Commission makes absolutely no effort to compensate for this obvious error.
- The NPRM also bases its national extension component on confidential call distribution data obtained from AT&T.<sup>133/</sup> This data is not in the record. Thus, there is absolutely no way for the foreign carriers, whose settlement rates the Commission proposes to establish, to verify its accuracy.
- The NPRM assumes that the "average network cost" figure supplied by AT&T is sufficient to serve as the lower bound of the benchmark range.<sup>134/</sup> Yet neither the Commission, nor any of the parties, have any way of evaluating this figure, which AT&T did not bother to substantiate, either in its two page letter (dated only three days before the release of the NPRM) or in its single page attachment to its comments.<sup>135/</sup> Nevertheless, the NPRM proceeds to rely on AT&T's figure

<sup>131/</sup> NPRM ¶ 45.

<sup>132/</sup> See Comments of Telefónica Internacional at 55; Comments of Hong Kong Telecom International at 12.

<sup>133/</sup> See Comments of ABS-CBN Telecom North America, Inc., IB Docket No. 96-261, at 5-7 (filed Feb. 7, 1997).

<sup>134/</sup> See Comments of Cable & Wireless at 15.

<sup>135/</sup> Letter to Donald Gips, Chief, International Bureau, Federal Communications Commission, from R. Gerald Salemme, Vice-President, Government Affairs, AT&T (Dec. 16, 1996); Comments of AT&T at Attach. E.

"as a starting point to derive a preliminary estimate of incremental cost."<sup>136/</sup>

- The NPRM assumes that the use of private circuit prices is an appropriate estimate for switched traffic prices. Yet, as Telefónica Internacional explained in its initial comments, private line and switched traffic are subject to entirely different sets of risks and returns. As a result, tariffed prices for private circuits are an inaccurate and inappropriate proxy for determining the costs of providing public switched service.<sup>137/</sup>
- The NPRM assumes that a 4:1 multiplication ratio is appropriate for all carriers because "the general practice among U.S. carriers is to derive four voice grade circuits from a 65 Kbps half-channel. . ." The NPRM fails to back up this statement with any data that such a practice is universal.<sup>138/</sup>
- The NPRM assumes that 8,000 minutes per circuit per month is a reliable estimate of usage on all routes. Again, the NPRM provides no support for this assumption, and even acknowledges that "[m]onthly minutes transmitted over international circuits vary from country to country, from carrier to carrier, and from month to month."<sup>139/</sup>
- The NPRM assumes that exchange rates are appropriate to price the TCPs in U.S. dollars. Yet using exchange rate significantly underestimates the costs of most carriers. While this problem can be corrected by using Purchasing Power Parity, the NPRM does not do so.<sup>140/</sup>

In sum, the NPRM proposes to impose mandatory benchmarks based on foreign carriers' costs. At the same time, the Commission has neither the information necessary to base its benchmarks on actual costs, nor does it employ a method that

<sup>136/</sup> International Bureau Report at 8.

<sup>137/</sup> See Comments of Telefónica Internacional at 57-58.

<sup>138/</sup> See *id.* at 58.

<sup>139/</sup> NPRM ¶ 55; International Bureau Report at 8.

<sup>140/</sup> See Comments of Telefónica Internacional at 59-63.

accurately estimates these costs. Instead, it uses a method which is more akin to guesswork than to reasoned estimation. Such guesswork should not serve as the basis for agency rate-making.

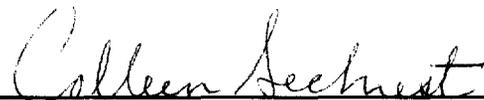
## **IX. CONCLUSION**

For the reasons set forth above and in Telefónica Internacional's initial comments, the Commission lacks both a sound legal and factual basis for adopting the NPRM's proposals for mandatory settlement rate benchmarks. Instead, the Commission should join in the work of the numerous foreign governments and foreign carriers who have urged a multilateral approach to reducing settlement rates.

Dated: March 31, 1997

Respectfully submitted,

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