services.[229] Price cap regulation of a BOC interLATA affiliate's interLATA services may deter a BOC from raising the costs of its affiliate's rivals through discrimination or other anticompetitive conduct by limiting the profit the affiliate could earn as a result of the anticompetitive conduct.[230] Nevertheless, the fact that these measures might help to deter a BOC or its interLATA affiliate from engaging in certain types of anticompetitive conduct is not, by itself, a sufficient basis for imposing dominant carrier regulations on the BOC interLATA affiliates. We should also consider whether and to what extent these regulations would dampen competition and whether other statutory and regulatory provisions would accomplish the same objectives while imposing fewer burdens on the carriers and the Commission. Dominant carrier regulation should be imposed on the BOC interLATA affiliates only if the benefits of such regulation outweigh the burdens that would be imposed on competition, service providers, and the Commission.[231]

88. The Commission has long recognized that the regulations associated with dominant carrier classification can dampen competition.[232] For example, advance notice periods for tariff filings can stifle price competition and marketing innovation when applied to a competitive industry.[233] In the Tariff Forbearance Order, we eliminated tariff filing requirements for non-dominant carriers pursuant to our forbearance authority under the Communications Act and ordered all non-dominant interexchange carriers to cancel their tariffs for interstate, domestic, interexchange services within nine months from the effective date of the Order.[234] We concluded that a regime without non-dominant interexchange

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[229] AT&T Aug. 15, 1996 Comments at 66; MCI Aug. 15, 1996 Comments at 64-65; Time Warner Aug. 15, 1996 Comments at 39.

[230] As we stated in the Notice, however, price cap regulation of a BOC interLATA affiliate's interLATA services generally would not prevent a BOC from raising its affiliate's rivals costs through discrimination or other anticompetitive conduct. Non-Accounting Safeguards NPRM at ¶ 132. It also would not prevent the affiliate from profiting from the BOC's raising rivals' costs through increased market share. Id. See also DOJ Aug. 30, 1996 Reply at 28 (impact of price cap regulation on affiliate pricing, and therefore its deterrence effect, is not so clear).

[231] Foreign Carrier Entry Order, 11 FCC Rcd at 3973 (finding that the benefits derived from requiring the submission of cost support data were, as a general rule, outweighed by the burden imposed by the filing requirement).

[232] Competitive Carrier First Report and Order, 85 FCC 2d at 34-44, ¶¶ 99-129; AT&T Reclassification Order, 11 FCC Rcd at 3288, ¶ 27.

[233] Tariff Forbearance Order at ¶ 53.

[234] Tariff Forbearance Order at ¶ 3. As previously noted, the Tariff Forbearance Order is currently subject to a judicial stay. See supra n. 8.

carrier tariffs for interstate, domestic, interexchange services will be the most pro-competitive, deregulatory system. We also found that not permitting non-dominant interexchange carriers to file tariffs with respect to interstate, domestic, interexchange services will enhance competition among providers of such services, promote competitive market conditions, and achieve other objectives that are in the public interest.[235] We further concluded that continuing to require non-dominant interexchange carriers to file tariffs for interstate, domestic, interexchange services would reduce incentives for competitive price discounting, constrain carriers' ability to make rapid, efficient responses to changes in demand and cost, impose costs on carriers that attempt to make new offerings, and prevent customers from seeking out or obtaining service arrangements specifically tailored to their needs.[236]

89. Requiring the BOC interLATA affiliates to file tariffs on advance notice and with cost support data would impose even more significant costs and burdens on the interLATA affiliates than the one-day notice period formerly required of non-dominant carriers and would adversely affect competition.[237] Moreover, these requirements could undermine at least some of the benefits otherwise gained by eliminating tariff filing by non-dominant domestic interexchange carriers. In the Tariff Forbearance Order, we found that tacit coordination of prices for interstate, domestic, interexchange services, to the extent it exists, would be more difficult if we eliminate tariffs, because price and service information about such services provided by non-dominant interexchange carriers would no longer be collected and available in one central location.[238] Upon full implementation of that Order, no interexchange carrier will be obligated (or permitted) to file tariffs for interstate, domestic, interexchange services.[239] If we were to require BOC interLATA affiliates to file tariffs for interstate, domestic, interexchange services, the ready availability of that information might facilitate tacit coordination of prices. We also believe that such requirements would impose

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[235] Tariff Forbearance Order at ¶ 52.

[236] Id. at ¶ 53.

[237] See AT&T Reclassification Order, 11 FCC Rcd at 3288, ¶ 27. Accord Ameritech Aug. 15, 1996 Comments at 34 (advance notice of pricing and service initiation would deny BOC interLATA affiliates first-mover advantage that they would otherwise obtain and make them a step slower in the marketplace); PacTel Aug. 15, 1996 Comments at 67-68 (whatever the BOC interLATA affiliates' final prices, competitors would undercut them by a penny or two and thereby preserve their market share); SBC Aug. 15, 1996 Comments at 17 (lengthy tariff proceedings would allow competitors to access valuable cost and planning information, decreasing the opportunity for more effective competition); DOJ Aug. 30, 1996 Reply at 29.

[238] Tariff Forbearance Order at ¶ 52.

[239] Upon full implementation of this Order, all domestic interexchange carriers will be regulated as non-dominant carriers. See infra section IV.B.

significant administrative burdens on the Commission and the BOC interLATA affiliates, particularly to the extent they encourage the affiliates' interLATA competitors to challenge the affiliates' interLATA rates in order to impede the affiliates' ability to compete.[240]

90. We find that the other regulations associated with dominant carrier classification can also have undesirable effects on competition. Although a price floor might help prevent a BOC interLATA affiliate from pricing below its cost, a price floor, if set too high, could prevent consumers from enjoying lower prices resulting from real efficiencies. The required cost support data can also discourage the introduction of innovative new service offerings, because it requires a carrier to reveal its financial information to its competitors.[241]

91. As we discussed in the Notice, we believe that other regulations applicable to the BOCs and their interLATA affiliates will address the anticompetitive concerns raised in the Notice in a less burdensome manner. For example, a BOC's ability to engage in a "price squeeze" by raising its prices for access services[242] (as opposed to a BOC affiliate's lowering its long distance prices even when the BOC has not lowered its access prices) is limited by price cap regulation of those services. The nondiscrimination and structural separation requirements set forth in section 272 and our rules thereunder, price cap regulation of the BOCs' exchange access services, and the Commission's affiliate transaction rules sufficiently reduce the risk of successful anticompetitive discrimination and improper allocation of costs.[243] We agree with DOJ that applying dominant carrier regulation to an affiliate in a downstream market would be "at best a clumsy tool for controlling vertical leveraging of market power by the parent, if the parent can be directly regulated instead."[244] In the Non-Accounting Safeguards Order and Accounting Safeguards Order, we adopted regulations to

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[240] DOJ Aug. 30, 1996 Reply at 29. See also Ameritech Aug. 15, 1996 Comments at 35 (incumbent interexchange carriers would routinely challenge tariffs of BOC interLATA affiliates on the "most flimsy of grounds").

[241] DOJ notes that our rules would require the BOC interLATA affiliates, if classified as dominant, to report costs incurred from sources independent of their parent companies, which would be of little or no relevance to any cost misallocation problem. DOJ Aug. 30, 1996 Reply at 28.

[242] Under this scenario, a BOC would raise the price of access to all interexchange carriers, including its affiliate. This would cause competing interLATA carriers either to raise their retail interLATA rates in order to maintain the same profit margins or to attempt to preserve their market share by not raising their prices to reflect the increase in access charges, thereby reducing their profit margins. If the competing in-region interLATA service providers raised their prices to recover the increased access charges, the BOC interLATA affiliate could seek to expand its market share by not matching the price increase. See infra ¶ 125.

[243] See infra ¶¶ 103-119.

[244] DOJ Aug. 30, 1996 Reply at 27.

constrain the BOCs' ability to use their market power in local exchange and exchange access services to engage in anticompetitive conduct in competitive markets. We therefore reject AT&T and MCI's contention that a BOC's ability to engage in such conduct would provide a legitimate basis for classifying its affiliate as dominant in the provision of in-region, interstate, domestic, interLATA services.

92. We find that the entry of the BOC interLATA affiliates into the provision of interLATA services has the potential to increase price competition and lead to innovative new services and marketing efficiencies.[245] We see no reason to saddle the BOC interLATA affiliates with regulations that are not well-suited to prevent the risks associated with BOC entry into in-region, interstate, domestic, interLATA services. We, therefore, conclude that the BOC interLATA affiliates should be classified as dominant carriers only if they have the ability to raise prices by restricting their own output.

2. Classification of BOC InterLATA Affiliates in the Provision of In-Region, Interstate, Domestic, InterLATA Services

a. Traditional Market Power Factors (other than control of bottleneck facilities)

i. Background

93. In the Non-Accounting Safeguards NPRM, we noted that, in determining whether a firm possesses market power, the Commission has previously focused on certain well-established market features, including market share, supply and demand substitutability, the cost structure, size or resources of the firm, and control of bottleneck facilities.[246] We sought comment on the application of these factors in determining whether the BOC interLATA affiliates should be classified as dominant or non-dominant.

ii. Comments

94. Most commenters that address the issue agree that each of the traditional

[245] See Bell Atlantic Aug. 15, 1996 Comments, Taylor Aff. at 12.

[246] Non-Accounting Safeguards NPRM at ¶ 133.

market factors weighs in favor of classifying the BOC interLATA affiliates as non-dominant.[247] According to Ameritech, it is inconceivable that a BOC interLATA affiliate "could bring AT&T to its knees quickly" because the affiliates will enter the long-distance market with no customers, no traffic, no revenues, and no presubscribed lines and will be competing against some 500 incumbent carriers, including AT&T, MCI and Sprint, all of which are well-established in the market.[248] Ameritech and U S West also claim that, in considering whether to classify the BOC interLATA affiliates as dominant, the Commission should consider only whether the BOC interLATA affiliates will have market power upon entry, not whether they will "quickly gain" such market power.[249]

95. The California Cable Television Association (CCTA) contends, however, that a BOC interLATA affiliate's initial zero market share should not dissuade the Commission from retaining dominant carrier regulation because, as an entity affiliated with the dominant provider in the state, it will have enormous advantages particularly in terms of brand identification. CCTA further argues that it is likely that these affiliates will seek to capitalize on their parental lineage by using some or all of the BOCs' logos or other branding mechanisms.[250] LDDS asserts that market share in and of itself is not a measure of market power, but rather is one of many possible indications that market power may exist in a certain market.[251]

iii. Discussion

96. We find that each of the traditional market factors (excluding bottleneck control) supports a conclusion that the BOC interLATA affiliates will not have the ability to raise price by restricting their output upon entry or soon thereafter. As stated in the Notice, the fact that each BOC interLATA affiliate initially will have zero market share in the provision of in-region, interstate, domestic, interLATA services suggests that the affiliate

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[247] See e.g., Ameritech Aug. 15, 1996 Comments at 8-12; BellSouth Aug. 15, 1996 Comments at 50; PacTel Aug. 15, 1996 Comments at 52; U S West Aug. 15, 1996 Comments at 45; USTA Aug. 15, 1996 Comments at 44.

[248] Ameritech Aug. 15, 1996 Comments at 8.

[249] Ameritech Aug. 15, 1996 Comments at 9-10; U S West Aug. 15, 1996 Comments at 47-48. Compare Ameritech Aug. 15, 1996 Comments at 9 (if "quickly" means within a period of time longer than a year, regulating a BOC interLATA affiliate as dominant now would be premature).

[250] CCTA Aug. 15, 1996 Comments at 13-14.

[251] LDDS Aug. 30, Reply at 11.

will not initially be able to raise price by restricting its output.[252] As discussed in the Notice, however, we find that this factor is not conclusive in determining whether a BOC interLATA affiliate should be classified as dominant, because the affiliate's zero market share results from its exclusion from the market until now, and, the affiliate potentially could gain significant market share upon entry or shortly thereafter, because of its brand identification with in-region customers, possible efficiencies of integration, and the BOC's ability potentially to raise the costs of its affiliate's interLATA rivals.

97. As to supply substitutability, we note that the Commission has previously found that the excess capacity of AT&T's competitors is sufficient to constrain AT&T's exercise of market power.[253] In light of that finding, we conclude that AT&T and its competitors, which currently serve all interLATA customers, should be able to expand their capacity sufficiently to attract a BOC interLATA affiliate's customers if the affiliate attempts to raise its interLATA prices.[254] As we discussed in the Notice, the Commission also recently found that the purchasing decisions of most customers of domestic interexchange services are sensitive to changes in price, and customers would be willing to shift their traffic to an interexchange carrier's rival if the carrier raises its prices.[255] The existence of such demand substitutability supports the conclusion that the BOC interLATA affiliates will not have the ability to raise prices by restricting their output. Finally, given the presence of existing interexchange carriers, including such large well established carriers as AT&T, MCI, Sprint, and LDDS, we find that the cost structure, size, and resources of the BOC interLATA affiliates are not likely to enable them to raise prices above the competitive level for their domestic interLATA services.[256] Although the BOCs' brand identification and

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[252] Non-Accounting Safeguards NPRM at ¶ 133. Accord Ameritech Aug. 15, 1996 Comments at 8; BellSouth Aug. 15, 1996 Comments at 50; PacTel Aug. 15, 1996 Comments at 52; U S West Aug. 15, 1996 Comments at 45; USTA Aug. 15, 1996 Comments at 44.

[253] AT&T Reclassification Order, 11 FCC Rcd at 3303-05.

[254] Ameritech Aug. 15, 1996 Comments at 10; Bell Atlantic Aug. 15, 1996 Comments at 15; PacTel Aug. 15, 1996 Comments at 52.

[255] Non-Accounting Safeguards NPRM at ¶ 133 (citing AT&T Reclassification Order, 11 FCC Rcd at 3305-07); accord SBC Aug. 15, 1996 Comments at 18.

[256] Accord NYNEX Aug. 15, 1996 Comments at 54; BellSouth Aug. 15, 1996 Comments at 50; Ameritech Aug. 15, 1996 Comments at 11. See also AT&T Reclassification Order, 11 FCC Rcd at 3309 (finding that AT&T's cost structure, size and resources did not constitute "persuasive evidence" of market power). In the AT&T Reclassification Order, the Commission noted that the issue is whether a carrier's "lower costs, sheer size, superior resources, financial strength, and technical capabilities . . . 'are so great to preclude the effective functioning of a competitive market.'" Id. 11 FCC Rcd at 3309, ¶ 73 (quoting Competition in the Interstate Interexchange Marketplace, CC Docket No. 90-132, Report and Order, 6 FCC Rcd 5880, 5891-92).

possible efficiencies of integration may give the BOC interLATA affiliates certain cost advantages in attracting customers, their lack of nationwide facilities-based networks would appear to put them at a disadvantage relative to the four largest interexchange carriers, as noted by Ameritech, particularly because the cost of resold long distances services will generally exceed the marginal cost of providing those services.[257]

b. BOC Control of Bottleneck Access Facilities

i. Background

98. In the Non-Accounting Safeguards NPRM, we noted that, in assessing whether a BOC interLATA affiliate would possess market power in the provision of in-region, interstate, domestic, interLATA services, we must also consider the significance of the BOCs' current control of bottleneck exchange access facilities.[258] We noted the concern that a BOC's control of bottleneck access facilities would enable it to allocate costs improperly from its affiliate's interLATA services to the BOC's regulated exchange or exchange access services, discriminate against its affiliate's interLATA competitors, and potentially engage in a price squeeze against those competitors.[259] We therefore sought comment on whether the statutory and regulatory safeguards currently imposed on the BOCs and their affiliates are sufficient to prevent a BOC from engaging in such activities to such an extent that the BOC interLATA affiliates would quickly gain the ability to raise price by restricting output.[260]

ii. Comments

99. Some of the BOCs dispute the Commission's assumption that the BOCs have and will maintain control of bottleneck access facilities. These commenters argue that any control the BOCs may have once had in the exchange access market has been dissipated by the Commission's expanded interconnection initiatives, the 1996 Act and the Commission's implementing regulations, and the actions of various states.[261] In contrast, AT&T contends that the BOCs' monopoly control over local bottleneck facilities gives them market power in

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[257] Ameritech Aug. 15, 1996 Comments at 12.

[258] Non-Accounting Safeguards NPRM at ¶ 134 (citing Competitive Carrier First Report and Order, 85 FCC 2d at 21, ¶ 58 (control of bottleneck facilities is "prima facie" evidence of market power)).

[259] Id. at ¶¶ 135-41.

[260] Id. at ¶ 142.

[261] Ameritech Aug. 15, 1996 Comments at 13-17; PacTel Aug. 15, 1996 Comments at 53-54; U S West Aug. 15, 1996 Comments at 48-49.

the interexchange market.[262] Similarly, LDDS asserts that the BOCs will continue to possess market power in both the local exchange and exchange access markets, which translates into market power in the in-region interLATA market.[263] Many commenters also specifically address the three types of anticompetitive conduct listed above.

iii. Discussion

100. As noted in the Non-Accounting Safeguards NPRM, BOCs currently provide an overwhelming share of local exchange and exchange access services in areas where they provide such services -- approximately 99.1 percent of the market as measured by revenues.[264] Although the 1996 Act establishes a framework for eliminating entry barriers and thereby fostering local competition, the evidence to date indicates that such competition is still in its infancy. As a result, we conclude, solely for purposes of this proceeding, that the BOCs currently possess market power in the provision of local exchange and exchange access services in their respective regions, and we therefore must consider whether they can use that market power to give their interLATA affiliates the ability to raise the prices of in-region, interstate, domestic, interLATA services by restricting their own output of those services.

c. Improper Allocation of Costs

i. Comments

101. The BOCs and USTA assert that statutory and regulatory safeguards should prevent any improper cost allocations from occurring, particularly because all BOCs are subject to price-cap regulation, and a majority have adopted the no-sharing option.[265] PacTel asserts that the concern over improper cost allocation ignores current regulation of the BOCs and presumes the incompetence of both state and federal regulators.[266] AT&T counters that

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[262] AT&T Aug. 15, 1996 Comments at 62.

[263] LDDS Aug. 30, 1996 Reply at 12.

[264] Industry Analysis Division, Telecommunications Industry Revenue: TRS Worksheet Data, (Com. Car. Bur. Dec. 1996). Tables 18 and 15 show that BOC local and access revenues in 1995 were $65.6 billion, while CAPs and Competitive LECs local and access revenues both in and out of BOC regions were only $595 million.

[265] See e.g., Bell Atlantic Aug. 15, 1996 Comments at 16; Ameritech Aug. 15, 1996 Comments at 19; BellSouth Aug. 15, 1996 Comments at 51-53; PacTel Aug. 15, 1996 Comments at 55-57; NYNEX Aug. 15, 1996 Comments at 55-56; USTA Aug. 15, 1996 Comments at 45-46.

[266] PacTel Aug. 15, 1996 Comments at 55-56.

price cap regulation cannot eliminate the incentive to allocate costs improperly because both the initial caps and subsequent adjustments are generally set at least in part on the basis of the BOCs' profits during the preceding years.[267] The Economic Strategy Institute asserts that cost accounting methodologies and models leave room for manipulation and interpretation.[268] It also claims that improper cost allocation can lead to substantial cost advantages and facilitate a price squeeze.[269]

102. The BOCs and USTA contend that it defies economic sense to expect any of the BOC interLATA affiliates to drive AT&T, MCI, or Sprint from the long-distance market. Even if they could, these commenters assert, the facilities of that carrier would remain intact, ready for another firm to buy at distress sale prices.[270] AT&T, CTA, and DOJ argue, however, that the concerns expressed in the NPRM regarding improper cost allocation are too narrow. In addition to raising the possibility of predatory pricing, improper cost allocation may cause substantial harm to consumers, competition, and production efficiency.[271] For example, improper cost allocation could lead to higher prices for local exchange and exchange access services and could shift market share and profits to a BOC interLATA affiliate, even if the affiliate is less efficient than its competitors, thereby resulting in a loss of production efficiency.[272] AT&T asserts that such a strategy would be costless to the BOC, for it would recover its losses in the competitive market through contemporaneous higher rates in the non-competitive market. As a result, no subsequent recoupment would be necessary.[273] According to DOJ, the Commission must consider

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[267] AT&T Aug. 15, 1996 Comments at 64 n.56.

[268] Economic Strategy Inst. Aug. 30, 1996 Reply at 4.

[269] Id. at 5.

[270] See, e.g., Bell Atlantic Aug. 15, 1996 Comments at 16; PacTel Aug. 15, 1996 Comments at 57-58; Ameritech Aug. 15, 1996 Comments at 20; U S West Aug. 15, 1996 Comments at 50; USTA Aug. 15, 1996 Comments at 46-47. Bell Atlantic also argues that if predation would not drive out the major competitors, there is no way for a BOC to recoup predatory prices by charging prices above a competitive level, and therefore predatory pricing against any competitor makes no sense. Bell Atlantic Aug. 30, 1996 Reply at 21-22.

[271] AT&T Aug. 15, 1996 Comments at 63; CTA Aug. 15, 1996 Comments at 35; DOJ Aug. 30, 1996 Reply at 24.

[272] DOJ Aug. 30, 1996 Reply at 24-25; AT&T Aug. 30 Reply at 35. AT&T also contends that discrimination itself produces another form of cost misallocation because an affiliate that receives favored treatment is essentially being undercharged for those services and the BOC is improperly bearing the extra costs. AT&T Aug. 15, 1996 Comments at 63-64.

[273] AT&T Aug. 30, 1996 Reply at 36.

whether applicable regulation would prevent improper cost allocation that would result in these adverse effects on consumers, competition, and production efficiency. DOJ argues that regulation alone will not prevent competitively significant improper cost allocations. The incentives to engage in such practices, according to DOJ, will be eliminated only when the local exchange market is subject to robust competition.[274]

ii. Discussion

103. As noted in the Non-Accounting Safeguards NPRM, improper allocation of costs by a BOC is of concern because such action may allow a BOC to recover costs from subscribers to its regulated services that were incurred by its interLATA affiliate in providing competitive interLATA services. In addition to the direct harm to regulated ratepayers, this practice can distort price signals in those markets and may, under certain circumstances, give the affiliate an unfair advantage over its competitors.[275] Recognizing this concern, Congress established safeguards in section 272, which we have implemented in the Non-Accounting Safeguards Order and Accounting Safeguards Order. For purposes of determining whether the BOC interLATA affiliates should be classified as dominant, however, we must consider only whether the BOCs could improperly allocate costs to such an extent that it would give the BOC interLATA affiliates, upon entry or soon thereafter, the ability to raise prices by restricting their own output. We conclude that, in reality, such a situation could occur only if a BOC's improper allocation enabled a BOC interLATA affiliate to set retail interLATA prices at predatory levels (i.e., below the costs incurred to provide those services), drive out its interLATA competitors, and then raise and sustain retail interLATA prices significantly above competitive levels.[276]

104. We conclude that applicable statutory and regulatory safeguards are likely to be sufficient to prevent the BOCs from improperly allocating costs between their monopoly local exchange and exchange access services and their affiliates' competitive interLATA services to such an extent that their interLATA affiliates would be able to eliminate other interLATA service providers and subsequently earn supra-competitive profits by charging monopoly prices. Section 272(b) includes a number of structural safeguards that constrain a BOC's ability to allocate costs improperly. For example, the provision requires a BOC interLATA affiliate to "operate independently" from the BOC,[277] maintain separate books,

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[274] DOJ Aug. 30, 1996 Reply at 25.

[275] Non-Accounting Safeguards NPRM at ¶ 135.

[276] Id. In so concluding, we do not dismiss cost misallocation as a potential problem. We recognize that the BOCs may have an incentive to misallocate the costs of their interLATA affiliates' interLATA services.

[277] 47 U.S.C. § 272(b)(1).

records, and accounts from the BOC,[278] and have separate officers, directors, and employees.[279] Section 272 also requires each BOC "to obtain and pay for a joint Federal/State audit every 2 years conducted by an independent auditor to determine whether such company has complied with [section 272] and the regulations promulgated under this section . . . ."[280] As noted by Ameritech and Bell Atlantic, the structural separation and audit requirements mandated in section 272 should reduce the risk of improper allocation of costs by minimizing the amount of joint costs that could be improperly allocated.[281] In the Non-Accounting Safeguards Order, we adopted rules to implement and clarify these provisions. For example, we concluded that the requirement that the BOC and its affiliate operate independently precludes the joint ownership of transmission and switching facilities by a BOC and its interLATA affiliate, as well as the joint ownership of the land and buildings where those facilities are located.[282] We also concluded that operational independence precludes a section 272 affiliate from performing operating, installation, and maintenance functions associated with the BOC's facilities. Likewise, it bars a BOC or any BOC affiliate, other than the section 272 affiliate itself, from performing operating, installation, or maintenance functions associated with the facilities that the section 272 affiliate owns or leases from a provider other than the BOC with which it is affiliated.[283] As noted by BellSouth, the separate employee requirement should ensure that the cost of each

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[278] 47 U.S.C. § 272(b)(2).

[279] 47 U.S.C. § 272(b)(3).

[280] 47 U.S.C. § 272(d)(1). The results of such audits must be submitted to the Commission and the state commissions in each State in which the BOC provides services, which shall make such results available for public inspection. Id. § 272(d)(2).

[281] Ameritech Aug. 15, 1996 Comments at 20; Bell Atlantic Aug. 15, 1996 Comments at 17; see also PacTel Aug. 15, 1996 Comments at 56.

[282] Non-Accounting Safeguards Order at ¶158. We noted that prohibiting joint ownership of transmission and switching facilities would ensure that an affiliate must obtain any such facilities pursuant to the arm's length requirements of section 272(b)(5), thereby facilitating monitoring and enforcement of the section 272 requirements. Id. at ¶ 160.

[283] Id. at ¶ 158. We concluded, however, consistent with these requirements and those established pursuant to sections 272(b)(5) and 272(c)(1), a section 272 affiliate may negotiate with an affiliated BOC on an arm's length and nondiscriminatory basis to obtain transmission and switching facilities, to arrange for collocation of facilities, and to provide or to obtain services such as administrative and marketing services. Id. We also clarified that section 272(b)(1) does not preclude a BOC or a section 272 affiliate from providing telecommunications services to one another, so long as each entity performs itself, or obtains from an unaffiliated third party, the operating, installation, and maintenance functions associated with the facilities that it owns or leases from an entity unaffiliated with the BOC. Id. at ¶ 164.

employee will be attributed directly to the appropriate entity.[284]

105. Section 272 also requires a BOC interLATA affiliate to conduct all transactions with the BOC on an arm's length basis, and all such transactions must be reduced to writing and made available for public inspection.[285] In the Accounting Safeguards Order, we concluded that, to satisfy this requirement, a section 272 affiliate must, at a minimum, provide a detailed written description of the asset or service transferred and the terms and conditions of the transaction on the Internet within 10 days of the transaction through the company's Internet home page.[286] We conclude that these safeguards will constrain a BOC's ability to allocate costs improperly and make it easier to detect any improper allocation of costs that may occur.

106. We further find that price cap regulation of the BOCs' access services reduces the BOCs' incentive to allocate improperly the costs of their affiliates' interLATA services. As the Commission previously explained, "[b]ecause price cap regulation severs the direct link between regulated costs and prices, a carrier is not able automatically to recoup improperly allocated nonregulated costs by raising basic service rates, thus reducing the incentive for the BOCs to shift nonregulated costs to regulated services."[287] We recognize that under our current interim LEC price cap rules, a BOC can select an X-factor option that requires it to share interstate earnings with its customers that exceed specified benchmarks and permit the BOC to make a low-end adjustment if interstate earnings fall below a specified threshold.[288] Consequently, in certain circumstances, a BOC may have an incentive to allocate costs from interLATA services to access services in order to reduce the amount of profits the BOC is required to share with its interstate access service customers or become eligible for a low-end adjustment.[289] We note, however, that only one of the BOCs currently

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[284] BellSouth Aug. 15, 1996 Comments at 52.

[285] 47 U.S.C. § 272(b)(5).

[286] Accounting Safeguards Order at ¶ 122. This information also must be made available for public inspection at the principal place of business of the BOC. Id.

[287] Amendment of Section 64.702 of the Commission's Rules and Regulations, CC Docket No. 85-229, BOC Safeguards Order, 6 FCC Rcd 7571, 7596, ¶ 55 (1991), vacated in part and remanded on other grounds, California v. FCC, 39 F.3d 919 (9th Cir. 1994), cert. denied, 115 S. Ct. 1427 (1995).

[288] The X-factor is a component of the price cap formula that is used to adjust the price cap index for a LEC's access services each year to account for changes in telephone companies' costs per unit of output.

[289] Time Warner Aug. 15, 1996 Comments at 12-13. Similarly, the possibility of future re-calibration of price cap levels or out-of-band filings also implies that price cap regulation does not fully sever the link between regulated costs and prices. See 47 C.F.R. § 61.49(e), (f).

has adopted a sharing option.[290] Our affiliate transaction rules, which apply to transactions between the BOCs and their interLATA affiliates,[291] should make it more difficult for a BOC to allocate improperly the costs of its affiliates' interLATA services. We also recognize that, if a state does not impose price cap regulation on a BOC's local exchange services, the BOC may have an incentive to allocate costs from interLATA services to its local exchange services. It appears, however, that many states have adopted price cap regulation or some other alternative form of regulation for the BOCs' local exchange services.[292] Moreover, we are not persuaded that dominant carrier regulation of the BOC interLATA affiliates' interLATA services would prevent such improper cost allocation.

107. Furthermore, even if a BOC were able to allocate improperly the costs of its affiliate's interLATA services, we conclude that it is unlikely that a BOC interLATA affiliate could engage successfully in predation.[293] At least four interexchange carriers -- AT&T, MCI, Sprint, and LDDS WorldCom -- have nationwide, or near-nationwide, network facilities that cover every BOC region.[294] These are large well-established companies with millions of customers throughout the nation. It is unlikely, therefore, that a BOC interLATA affiliate, whose customers are likely to be concentrated in the BOC's local service region,[295]

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[290] U S West is the only BOC currently subject to a sharing option. Data based on 1996 Annual Access Tariff Filings filed on April 2, 1996. See also USTA Aug. 15, 1996 Comments, Hausman Aff. at 8. We also note that the Commission has sought comment on whether the sharing option should be eliminated. Price Cap Performance Review for Local Exchange Carriers, Fourth Further Notice of Proposed Rulemaking, 10 FCC Rcd 13659, 13679 (1995). Also, in the Access Charge Reform NPRM, we sought comment on whether we should reinitialize price cap indices and increase the X-factor. See Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Transport Rate Structure and Pricing; Usage of the Public Switched Network by Information Service and Internet Access Providers, CC Docket Nos. 96-262, 94-1, 91-213, 26-263, Notice of Proposed Rulemaking, Third Report and Order, and Notice of Inquiry, FCC No. 96-XX, at ¶¶ 223-35 (rel. Dec. 24, 1996) (Access Charge Reform NPRM).

[291] See Accounting Safeguards Order at ¶ 176.

[292] See National Association of Regulatory Utility Commissioners, Utility Regulatory Policy in the United States and Canada: Compilation 1995-1996 at 253, 268 (1997).

[293] See Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 589 (1986) ("[P]redatory pricing schemes are rarely tried, and even more rarely successful.") See also Bell Atlantic Comments at 16; PacTel Aug. 15, 1996 Comments at 57-58; Ameritech Aug. 15, 1996 Comments at 20; U S West Aug. 15, 1996 Comments at 50; USTA Aug. 15, 1996 Comments at 45-47.

[294] AT&T Reclassification Order, 11 FCC Rcd at 3304, ¶¶ 60-61.

[295] We recognize that action taken in concert by two or more BOCs could have a more significant impact on interLATA competitors, but believe that the antitrust laws and our enforcement process will sufficiently limit the risk of such concerted activity. Non-Accounting Safeguards Order at ¶ 70.

could drive one or more of these national companies from the market. Even if it could do so, it is doubtful that the BOC interLATA affiliate would later be able to raise prices in order to recoup lost revenues.[296] As Professor Spulber has observed, "[e]ven in the unlikely event that [a BOC interLATA affiliate] could drive one of the three large interexchange carriers into bankruptcy, the fiber-optic transmission capacity of that carrier would remain intact, ready for another firm to buy the capacity at distress sale and immediately undercut the [affiliate's] noncompetitive prices."[297]

108. We acknowledge that improper cost allocation may raise concerns beyond the risk of predatory pricing. As AT&T and DOJ assert, exploiting improper cost allocation to divert business to BOC interLATA affiliates from other, more efficient suppliers would be anticompetitive even if the latter suppliers remained in the market.[298] DOJ contends that this strategy would produce inefficiencies and wasted resources and reduce future investment by competitors to improve or expand their networks and to develop innovative technologies and services.[299] AT&T claims that such a strategy would be costless to the BOC, for it would recover its losses in the competitive market through contemporaneous higher rates in the non-competitive market, and, consequently, subsequent recoupment would be unnecessary.[300] As previously stated, although we agree that these are serious concerns, we find that they do not establish a persuasive basis for classifying the BOC interLATA affiliates as dominant in the provision of in-region, interstate, domestic, interLATA services. Rather, such concerns are best addressed through enforcement of the section 272 requirements. We also note that DOJ contends that dominant carrier regulation will not prevent the BOCs from improperly allocating their affiliates' interLATA costs. In fact, DOJ asserts that the incentives to engage in such practices will be eliminated only when the local exchange market is subject to robust competition.[301] As previously discussed, we conclude that dominant carrier regulation generally would not help prevent a BOC from improperly allocating costs.[302]

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[296] See, e.g., Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 224 (1993) ("Recoupment is the ultimate object of an unlawful predatory pricing scheme; it is the means by which a predator profits from predation.")

[297] Daniel F. Spulber, Deregulating Telecommunications, 12 Yale J. on Reg. 25, 60 (1995).

[298] AT&T Aug. 30, 1996 Reply at 35; DOJ Aug. 30, 1996 Reply at 25.

[299] DOJ Aug. 30, 1996 Reply at 25.

[300] AT&T Aug. 30, 1996 Reply at 36.

[301] DOJ Aug. 30, 1996 Reply at 25.

[302] Ameritech Aug. 15, 1996 Comments at 33; Bell Atlantic Aug. 15, 1996 Comments at 15-16; PacTel Aug. 15, 1996 Comments at 55.

d. Unlawful Discrimination

i. Comments

109. The BOCs suggest that concerns over the BOCs' incentives to discriminate are grossly exaggerated, given increasing competition in exchange and exchange access services (particularly after a BOC has satisfied the competitive checklist and other requirements in section 271) and the potential problem that customers would attribute degradation in service quality to the BOCs, rather than their interLATA affiliates' competitors.[303] The BOCs further contend that, even if they did have the incentive to discriminate, they lack the ability to do so because of the nondiscrimination requirements in the 1996 Act and because of engineering obstacles to such selective degradation of service quality.[304] Several BOCs also argue that discrimination is unlikely to be effective unless it is apparent to customers. According to the BOCs, if it is apparent to customers, however, it also is likely to be apparent to their long distance carrier and regulators that have the authority to enjoin any illegal practices.[305] BellSouth and SBC contend that BOCs have a significant disincentive to provide inferior access to IXCs or otherwise jeopardize their relationship because the access charges paid by IXCs are a major source of revenue for the BOCs, and the IXCs increasingly will have the option of moving their exchange access traffic to alternative LECs and CAPs.[306] Bell Atlantic and USTA claim that the BOCs have a long history of operating in other markets related to their local exchange and exchange access services without any adverse economic effects. They claim that, in each of the businesses that the BOCs have been allowed to enter since divestiture -- cellular, voice messaging, customer premises equipment, and limited interLATA services -- output has grown, prices have fallen and

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[303] See, e.g., Ameritech Aug. 15, 1996 Comments at 22-23; Bell Atlantic Aug. 15, 1996 Comments at 17-18. Ameritech points to the cable television industry as an example of how the threat of imminent competition has forced firms to improve customer goodwill immediately in recognition that they would lose market share quickly once competition arrives. Ameritech Aug. 15, 1996 Comments at 23.

[304] See, e.g., Ameritech Aug. 15, 1996 Comments at 24-25; Bell Atlantic Aug. 15, 1996 Comments at 17; PacTel Aug. 15, 1996 Comments at 60; SBC Aug. 15, 1996 Comments at 19-20; USTA Aug. 15, 1996 Comments at 49-50. USTA asserts that no commenter provided examples or even anecdotal evidence that undetected selective degradation of access is possible. USTA Aug. 30, 1996 Reply at 28.

[305] Ameritech Aug. 15, 1996 Comments at 26-27; Bell Atlantic Aug. 15, 1996 Comments at 17; PacTel Aug. 15, 1996 Comments at 58-59; SBC Aug. 15, 1996 Comments at 19-20; NYNEX Aug. 15, 1996 Comments at 56-57. PacTel claims that not only must the degraded quality of the BOC interLATA affiliate's competitors be obvious to consumers, but they must also believe that the quality of the interLATA affiliate's service is better than anyone else's, which would require a massive advertising campaign touting the interLATA affiliate's superior service. PacTel Aug. 15, 1996 Comments at 59.

[306] BellSouth Aug. 15, 1996 Comments at 54; SBC Aug. 15, 1996 Comments at 19-20.

competitors have thrived.[307] PacTel asserts that, if such discriminatory behavior could happen, it would already have happened.[308]

110. A number of parties contend that, despite passage of the 1996 Act, BOCs have the incentive and ability to discriminate against their interLATA affiliates' long distance competitors.[309] AT&T argues that the BOCs can discriminate against interexchange competitors in numerous and subtle ways that would be difficult to police.[310] According to DOJ and Time Warner, the BOCs will retain the incentive and ability to discriminate against competitors until they are subject to actual, sustained competition in local telephone markets.[311]

ii. Discussion

111. In the Non-Accounting Safeguards NPRM, we noted that a BOC potentially could use its market power in the provision of local exchange and exchange access services to discriminate against its interLATA affiliate's interLATA competitors to gain an advantage for its interLATA affiliate.[312] We noted that there are various ways in which a BOC could attempt to discriminate against unaffiliated interLATA carriers, such as through poorer quality interconnection arrangements or unnecessary delays in satisfying its competitors' requests to connect to the BOC's network.[313] Certain forms of discrimination may be difficult to police, particularly in situations where the level of the BOC's "cooperation" with unaffiliated interLATA carriers is difficult to quantify. To the extent customers value "one-stop shopping," degrading a rival's interexchange service may also undermine the attractiveness of the rival's interexchange/local exchange package and thereby strengthen the

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[307] Bell Atlantic Aug. 15, 1996 Comments at 18; USTA Aug. 15, 1996 Comments, Hausman Aff. at 11. See also PacTel Aug. 15, 1996 Comments at 59-60, 64-67; NYNEX Aug. 15, 1996 Comments at 56-57.

[308] PacTel Aug. 15, 1996 Comments at 59. According to PacTel, it has competed with interexchange carriers in the provision of intraLATA toll services and with enhanced services providers since the 1980s, and it has not been subject to complaints of discrimination for these services. Id.

[309] See e.g., Excel Aug. 15, 1996 Comments at 9; Frontier Aug. 15, 1996 Comments at 8; Time Warner Aug. 30, 1996 Reply at 22-23; DOJ Aug. 30, 1996 Reply at 16. See also LDDS Comments at 20.

[310] AT&T Aug. 15, 1996 Comments at 63.

[311] Time Warner Aug. 30, 1996 Reply at 24; DOJ Aug. 30, 1996 Reply at 16.

[312] Non-Accounting Safeguards NPRM at ¶ 139.

[313] Id.

BOC's dominant position in the provision of local exchange services.[314] We continue to be concerned that a BOC could attempt to discriminate against unaffiliated interLATA carriers. For purposes of determining whether the BOC interLATA affiliates should be classified as dominant, however, we need to consider only whether a BOC could discriminate against its affiliate's interLATA competitors to such an extent that the affiliate would gain the ability to raise prices by restricting its own output upon entry or shortly thereafter.

112. The 1996 Act contains a number of nondiscrimination safeguards, which we have implemented in the Non-Accounting Safeguards Order and Accounting Safeguards Order. For example, section 272(c)(1) prohibits a BOC, in its dealings with its section 272 affiliate, from "discriminat[ing] between that company or affiliate and any other entity in the provision or procurement of goods, services, facilities, and information, or in the establishment of standards."[315] In the Non-Accounting Safeguards Order, we concluded that section 272(c)(1) requires a BOC to provide unaffiliated entities the same goods, services, facilities, and information that it provides to its section 272 affiliate at the same rates, terms, and conditions.[316] We also concluded that a prima facie case of discrimination would exist under section 272(c)(1) if a BOC does not provide unaffiliated entities the same goods, services, facilities, and information that it provides to its section 272 affiliate at the same rates, terms, and conditions.[317] In addition, we concluded that, to the extent a BOC develops new services for or with its section 272 affiliate, it must develop new services for or with unaffiliated entities in the same manner.[318]

113. Section 272(e) also includes a number of specific nondiscrimination requirements. For example, section 272(e)(1) requires a BOC to "fulfill any requests from an unaffiliated entity for telephone exchange service and exchange access within a period no longer than the period in which it provides such telephone exchange service and exchange access to itself or its affiliates."[319] In the Non-Accounting Safeguards Order, we concluded

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[314] Id.

[315] 47 U.S.C. § 272(c)(1).

[316] Non-Accounting Safeguards Order at ¶ 202.

[317] Non-Accounting Safeguards Order at ¶ 212. To rebut the complainant's case, the BOC may demonstrate, among other things, that rate differentials between the section 272 affiliate and unaffiliated entity reflect differences in cost, or that the unaffiliated entity expressly requested superior or less favorable treatment in exchange for paying a higher or lower price to the BOC. Id.

[318] Id. at ¶ 210.

[319] 47 U.S.C. § 272(e)(1).

that the term "requests" includes, but is not limited to, initial installation requests, subsequent requests for improvement, upgrades or modifications of service, or repair and maintenance of these services.[320] We also concluded that BOCs must disclose to unaffiliated entities information regarding service intervals in which BOCs provide service to themselves or their affiliates.[321] This disclosure requirement should promote compliance with section 272(e)(1) and allow competitors to resolve disputes informally rather than using the Commission's formal complaint process.[322]

114. Section 272(e)(2) restricts the ability of a BOC to provide "facilities, services, or information concerning its provision of exchange access to [its affiliate,] unless [it makes] such facilities, services, or information . . . available to other providers of interLATA services in that market on the same terms and conditions."[323] Coupled with existing equal access and network disclosure requirements, this provision will limit the BOCs' ability to discriminate in the provision of such facilities, services, and information.

115. Section 272(e)(3) requires that a BOC charge its affiliate "an amount for access to its telephone exchange service and exchange access that is no less than the amount [that the BOC charges] any unaffiliated interexchange carriers for such service."[324] In the Non-Accounting Safeguards Order, we recognized that this provision serves to constrain a BOC's ability to engage in discriminatory pricing of its exchange and exchange access service.[325]

116. We also find that the structural separation requirements of section 272(b) will constrain a BOC's ability to discriminate against its affiliate's interLATA competitors. As previously noted, we have interpreted the section 272(b)(1) requirement that a section 272 affiliate "operate independently" from the BOC to prohibit the joint ownership of transmission and switching facilities by the BOC and its affiliate.[326] This requirement

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[320] Non-Accounting Safeguards Order at ¶ 239.

[321] Id. at ¶ 241. In the Order, we sought further comment on specific information disclosure requirements that were proposed by AT&T in an ex parte letter filed after the official pleading cycle closed. Id. at ¶ 244.

[322] Id. at ¶ 243.

[323] 47 U.S.C. § 272(e)(2).

[324] 47 U.S.C. § 272(e)(3).

[325] Non-Accounting Safeguards Order at ¶ 256.

[326] See supra ¶ 104.

ensures that an affiliate must obtain any such facilities on an arm's length basis pursuant to section 272(b)(5), thereby increasing the transparency of transactions between a BOC and its affiliates.[327] As we observed in the Non-Accounting Safeguards Order, "[t]ogether, the prohibition on joint ownership of facilities and the nondiscrimination requirements should ensure that competitors can obtain access to transmission and switching facilities equivalent to that which section 272 affiliates receive."[328]

117. We recognize that the nondiscrimination requirements in the Communications Act are effective only to the extent that they are enforced. To this end, the 1996 Act gives the Commission specific authority to enforce the requirements of section 272 and the other conditions for in-region, interLATA entry incorporated in section 271(d)(3).[329] Section 271(d)(6) provides that "[i]f at any time after the approval of a [BOC application under section 271(d)(3)], the Commission determines that a [BOC] has ceased to meet any of the conditions required for such approval, the Commission may, after notice and opportunity for a hearing - (i) issue an order to such company to correct the deficiency; (ii) impose a penalty on such company pursuant to title V; or (iii) suspend or revoke such approval."[330] In the Non-Accounting Safeguards Order, we concluded that this authority augments the Commission's existing enforcement authority.[331] Section 271(d)(6) also specifies that the Commission must act within 90 days on a complaint alleging that a BOC has failed to meet a condition required for in-region, interLATA approval under section 271(d)(3).[332]

118. In light of the 90-day deadline to act upon a 271(d)(6) complaint, we adopted certain measures in the Non-Accounting Safeguards Order to expedite the processing of these complaints.[333] For example, once a complainant has demonstrated a prima facie case that a

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[327] Non-Accounting Safeguards Order at ¶ 160. Section 272(b)(5) requires a BOC interLATA affiliate to "conduct all transactions with the [BOC] on an arm's length basis with any such transactions reduced to writing and available for public inspection." 47 U.S.C. § 272(b)(5).

[328] Non-Accounting Safeguards Order at ¶ 160.

[329] 47 U.S.C. § 271(d)(6).

[330] 47 U.S.C. § 271(d)(6)(A).

[331] Non-Accounting Safeguards Order at ¶ 333.

[332] 47 U.S.C. § 271(d)(6)(B).

[333] We also recently initiated a separate proceeding addressing the expedited complaint procedures mandated by this subsection as well as those mandated by other provisions of the 1996 Act. See Amendment of Rules Governing Procedures to be Followed When Formal Complaints are Filed Against Common Carriers, CC Docket No. 96-238, Notice of Proposed Rulemaking, FCC 96-460 (rel. Nov. 27, 1996).

defendant BOC has ceased to meet the conditions of entry, the burden of production (i.e., coming forward with evidence) will shift to the BOC defendant.[334] By shifting this burden of production, we have placed on the BOC an affirmative obligation to produce evidence and arguments necessary to rebut the complainant's prima facie case or face an adverse ruling.[335] In the Non-Accounting Safeguards Order, we also concluded that, in addressing complaints alleging that a BOC has ceased to meet the conditions required for the provision of in-region interLATA services, we will not employ a presumption of reasonableness in favor of the BOC interLATA affiliate, regardless of whether the BOC or BOC interLATA affiliate is regulated as a dominant or non-dominant carrier.[336] We believe that these enforcement mechanisms will allow us to adjudicate complaints against the BOCs and BOC interLATA affiliates in a timely manner.

119. We conclude that the statutory and regulatory safeguards discussed above will prevent a BOC from discriminating to such an extent that its interLATA affiliate would have the ability, upon entry or shortly thereafter, to raise the price of in-region, interstate, domestic, interLATA services by restricting its output.[337] We also conclude that imposing dominant carrier regulation on the BOC interLATA affiliates would not significantly aid in the prevention of most types of discrimination.[338] Although AT&T expresses concern about the risk of discrimination, it suggests that the Commission should impose stringent non-discrimination requirements and reporting obligations in order to combat this problem. It does not contend that dominant carrier regulation would help to prevent discrimination.[339] We are not persuaded by Time Warner's assertion that dominant carrier regulation is necessary to ensure that the BOCs comply with their statutory obligation to charge affiliates

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[334] Non-Accounting Safeguards Order at ¶ 345.

[335] The complainant, however, will have the ultimate burden of persuasion throughout the proceeding; that is, to show that the "preponderance of the evidence" produced in the proceeding weighs in its favor. Id.

[336] Id. at ¶ 351. The presumption of lawfulness given to nondominant carrier rates and practices is employed in the context of complaints alleging violations of sections 201(b) and 202(b), where the complaint must demonstrate that the defendant's rates and practices are "unjust and unreasonable." We found that a presumption of reasonableness is an irrelevant concept in the context of complaints alleging violations of the conditions of interLATA approval in section 271(d)(3), particularly given our interpretation of section 272(c)(1) as an unqualified prohibition on discrimination. Id.

[337] USTA Aug. 15, 1996 Comments at 48-51.

[338] Although the advance tariff filing requirement might help detect certain types of price discrimination, the marginal benefit of such regulation would be outweighed by the burdens such regulation would impose, as discussed above. See supra ¶¶ 88-90.

[339] See AT&T Aug. 15, 1996 Comments at 65-66.

rates equal to those charged unaffiliated carriers for telephone exchange and exchange access services.[340] Rather, as discussed above, we conclude that the section 272 safeguards, coupled with the expedited enforcement mechanism, should provide an adequate means of ensuring that the BOCs comply with this requirement.

e. Price Squeeze

i. Comments

120. The BOCs generally argue that they do not have the ability to engage in a price squeeze by raising prices because their access prices are regulated.[341] They also note that section 272(e)(3) requires BOCs to charge their affiliates the same access rates they charge unaffiliated carriers.[342] PacTel claims that a true price squeeze would occur only if the price charged by the BOC interLATA affiliate was less than the BOC's marginal cost of access, plus the foregone contribution from that access, plus the affiliate's cost of providing the long distance service.[343] PacTel contends that it would be irrational for a BOC interLATA affiliate to price below this level unless its object was predation, which is not a plausible strategy.[344] On the other hand, according to PacTel, a BOC interLATA affiliate's acceptance of little or no profit in order to expand its market share, by itself, would not be a price squeeze and would not be anticompetitive.[345] NYNEX claims that significant changes to local exchange service and access markets initiated by the Local Competition First Report and Order make it unreasonable to fear that BOC access pricing could result in its affiliate's attaining long distance market power, particularly in light of the Commission's commitment to undertake and complete access reform within the next year.[346]

121. Non-BOC commenters generally contend that the BOCs will have the incentive and ability to engage in a price squeeze, despite price cap regulation of the BOCs' access

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[340] Time Warner Aug. 30, 1996 Reply at 23.

[341] See, e.g., Ameritech Aug. 15, 1996 Comments at 30-31; PacTel Aug. 15, 1996 Comments at 62.

[342] Ameritech Aug. 15, 1996 Comments at 30-31; PacTel Aug. 15, 1996 Comments at 62; USTA Aug. 15, 1996 Comments at 50-51, Hausman Aff. at 12.

[343] PacTel Aug. 15, 1996 Comments at 61-62.

[344] PacTel Aug. 15, 1996 Comments at 62.

[345] Id. at 61.

[346] NYNEX Aug. 15, 1996 Comments at 57-58; NYNEX Aug. 30, 1996 Reply at 32.

services and other applicable safeguards. The Economic Strategy Institute asserts that antitrust and economic literature generally supports the need for regulatory intervention in cases of price squeezes.[347] MCI contends that the BOCs are most likely to exercise market power by assessing excessive prices for exchange access services for all carriers (including the BOCs' interLATA affiliates),[348] and price cap regulation will not prevent this tactic because access rates are already excessive.[349] MFS argues that, as long as a BOC is allowed to provide both essential services and competitive services, and as long as those essential services are priced above cost, a "vertically integrated" BOC can drive even more efficient rivals out of the market.[350] MFS and MCI further assert that a price squeeze would not be limited to price increases in access services, but could also arise from the contribution BOCs earn on stimulated demand for access services created by competitors' forced price reductions to match a BOC interLATA affiliate price reduction.[351] MCI claims that such a strategy could seriously harm competition. According to MCI, even if rivals remain in the market, they will be weakened by the cost increases they are forced to absorb, thereby reducing their output and the "vigors of competition."[352]

122. LDDS asserts that the structural separation, accounting, and imputation requirements in the Communications Act do not adequately address the BOCs' access cost advantage because: (1) there is no way to ensure that a BOC interLATA affiliate's costs, other than for access, are reflected in its prices; (2) to the extent customers buy bundled local exchange, long distance, and other services from a BOC interLATA affiliate, the BOC interLATA affiliate could effectively evade imputation requirements by passing on its access cost advantage in reduced prices for services not subject to the Commission's direct jurisdiction, such as local exchange and information services; (3) a BOC will have the incentive and ability to favor its interLATA affiliate over its competitors in the provision of bundled local exchange and interLATA services; and (4) a BOC has the ability to discriminate against its affiliate's interLATA competitors on terms other than price.[353]

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[347] Econ. Strategy Inst. Aug. 30, 1996 Reply at 2.

[348] MCI Aug. 15, 1996 Comments at 63.

[349] Id. at 64.

[350] MFS Aug. 15, 1996 Comments at 4; MFS Aug. 30, 1996 Reply at 23-24.

[351] MFS Aug. 30, 1996 Reply at 25; MCI Aug. 30, 1996 Reply at 35.

[352] MCI Aug. 30, 1996 Reply at 36-37.

[353] LDDS Aug. 15, 1996 Comments at 23-24.

123. MCI and AT&T argue that requiring cost support data and advance notice periods for tariff filings is important to ensure that the BOC interLATA affiliates are pricing their services above their costs.[354] MFS, however, questions whether regulating BOC interLATA affiliates as dominant firms would be effective in preventing price squeezes. It contends that the only effective mechanisms for preventing this behavior are pricing BOC essential services at economic cost and developing competitive alternatives to the BOCs' essential services.[355]

124. Ameritech disputes arguments that access charges are priced above economic costs and therefore will enable BOC interLATA affiliates to set interLATA rates below cost without incurring a loss. According to Ameritech, any subsidies in access are real costs that the BOC must recover in some manner in order to remain "whole." Ameritech also claims that price squeeze arguments ignore the fact that BOC interLATA affiliates will pay access charges to unaffiliated carriers when they originate or terminate long distance calls out-of-region and that facilities-based incumbent carriers actually have significant cost advantages.[356] Finally, Ameritech disputes the relevance of the price squeeze arguments. According to Ameritech, a BOC interLATA affiliate's ability to gain market share by setting rates below the cost of access would not constitute a basis for classifying the BOC interLATA affiliate as dominant.[357] Ameritech is aware of no legal theory under which such a practice could be considered unreasonable or otherwise unlawful, since consumers would suffer no harm unless the BOC interLATA affiliate could somehow acquire market power from its action.[358] Bell Atlantic and NYNEX claim that advance notice periods for tariff filings and cost support requirements are unnecessary to ensure compliance with the section 272 imputation requirement because the 1996 Act already provides for a biennial audit, which is intended to serve specifically as a check on compliance with the section 272 separation requirements, including the imputation requirement.[359]

ii. Discussion

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[354] MCI Aug. 15, 1996 Comments at 65; AT&T Aug. 15, 1996 Comments at 66.

[355] MFS Aug. 15, 1996 Comments at 4-5.

[356] Ameritech Aug. 30, 1996 Reply at 3-4.

[357] Id. at 2.

[358] Id.

[359] Bell Atlantic Aug. 30, 1996 Reply at 20; NYNEX Aug. 30, 1996 Reply at 33; see also PacTel Aug. 30, 1996 Reply at 32; USTA Aug. 15, 1996 Comments, Hausman Aff. at 12-13 (asserting that imputation has worked well in intraLATA long distance markets, such as those in California).

125. In the Non-Accounting Safeguards NPRM, we noted that, absent appropriate safeguards, a BOC potentially could raise the price of access to all interexchange carriers, including its affiliate.[360] This would cause competing interLATA carriers either to raise their retail interLATA rates in order to maintain the same profit margins or to attempt to preserve their market share by not raising their prices to reflect the increase in access charges, thereby reducing their profit margins.[361] If the competing in-region interLATA service providers raised their prices to recover the increased access charges, the BOC interLATA affiliate could seek to expand its market share by not matching the price increase. In that event, although the BOC interLATA affiliate would achieve lower profit margins than its rivals, all other things being equal, the BOC corporate entity as a whole would receive additional access revenues from unaffiliated carriers due to the access price increase and greater revenues from the affiliate's interLATA services caused by its increased share of interLATA traffic. If the BOC were to raise its access rates high enough, it would be impossible for interexchange competitors to compete effectively. Thus, the entry of a BOC's affiliate into the provision of in-region, interstate, domestic, interLATA services might give the BOC an incentive to raise its price for access services in order to disadvantage its affiliate's rivals, increase its affiliate's market share, and increase the profits of the BOC overall.[362]

126. We conclude, as discussed in the Notice, that price cap regulation of the BOCs' access services sufficiently constrains a BOC's ability to raise access prices to such an extent that the BOC affiliate would gain, upon entry or soon thereafter, the ability to raise prices of interLATA services above competitive levels by restricting its own output of those services.[363] Although a BOC may be able to raise its access rates to some extent if those rates are currently below the applicable price cap and could fail to pass along reductions in the cost of access if the productivity factor is too low,[364] we conclude that such an increase would not give a BOC affiliate the ability to raise prices of interLATA services above

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[360] Non-Accounting Safeguards NPRM at ¶141.

[361] See United States v. Aluminum Co. of America, 148 F.2d 416, 437-38 (2d Cir. 1945); Town of Concord v. Boston Edison Co., 915 F.2d 17, 18 (1st Cir. 1990).

[362] Non-Accounting Safeguards NPRM at ¶ 141. In the Notice, we recognized that the same situation could occur if a BOC failed to pass through to interexchange carriers a reduction in the cost of providing access services, and that price cap regulation would not be effective in eliminating the effect of a price squeeze initiated under these circumstances. Id. at ¶ 141 n.272.

[363] See NYNEX comments at 57. We also note that the emergence of competition in the provision of exchange access service may also constrain a BOC's ability to raise access prices. See id.; SBC Aug. 30, 1996 Reply at 27.

[364] Non-Accounting Safeguards NPRM at ¶ 141 n.272. But see Ameritech Aug. 15, 1996 Comments at 30 (noting that the Commission recently substantially increased the productivity index).

competitive levels by restricting its own output of those services.[365] We will consider the impact of such a potential increase on competition in the pending access charge reform proceeding. We also note that the ability of competing carriers to acquire access through the purchase of unbundled elements enables them to avoid originating access charges and thus partially protect themselves against a price squeeze.[366] To the extent that access charges are reformed to more closely reflect economic cost,[367] as is being considered in the access charge reform proceeding, the potential for a price squeeze should be further mitigated.[368]

127. Some commenters assert, however, that a BOC could engage in a price squeeze without raising the price of its access services. These commenters suggest that, because access services are currently priced above economic cost, a BOC interLATA affiliate could set its interLATA prices at or below the BOC's access prices and still be profitable.[369] The affiliate's interLATA competitors would then be faced with the choice of setting their prices at unprofitable levels or losing market share. Several BOCs respond that this would not be a profit-maximizing strategy because the increased revenues they would receive from the affiliate's interLATA services would be offset by a reduction in the access revenues received from unaffiliated carriers.[370] If the affiliate's reduction in interLATA rates sufficiently increased demand, however, it is possible the BOC interLATA affiliate's higher interLATA revenues would more than offset lost access revenues, assuming the affiliate's interLATA competitors do not match the affiliate's price reduction.[371] If, in the alternative,

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[365] See USTA Aug. 15, 1996 Comments at 50-51 (BOCs would not likely be able to manipulate their access charges enough, within the parameters of the price cap, so as to drive competitors of the BOC interLATA affiliate out of business).

[366] See 47 U.S.C. § 252(d)(1)(A)(i). The Commission's pricing rules interpreting section 252(d)(1)(A)(i) are currently under stay by the 8th Circuit Court of Appeals. Iowa Utilities Board v. FCC, No. 96-3321, 1996 WL 589284 (8th Cir. Oct. 15, 1996) (order granting stay pending judicial review).

[367] See Ameritech Aug. 15, 1996 Comments at 31.

[368] See Access Charge Reform NPRM at ¶ 14.

[369] MFS Aug. 15, 1996 Comments at 4-5; MCI Aug. 15, 1996 Comments at 63-64; MFS Aug. 30, 1996 Reply at 24-25.

[370] See PacTel Aug. 15, 1996 Comments at 63-64; Ameritech Aug. 15, 1996 Comments at 30 (if the BOCs had the ability to raise access prices substantially, they would have every incentive to do so now).

[371] See, e.g., MFS Aug. 15, 1996 Comments, attach. 1 (providing numerical illustration purporting to show that a BOC could engage in a price squeeze despite price cap regulation of the BOCs' access services or the imputation requirement); MCI Aug. 30, 1996 Reply at 35. But see USTA Aug. 30, 1996 Reply at 26-27, Hausman Aff. at 5 (claiming MFS' illustration fails to impute access prices at tariffed rates, and that when properly modified, the model indicates that the IXC with the lowest cost structure will have the lowest price