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USTA Reply to Opposition
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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934 as amended	)	CC Docket No. 96-149
	)	
and	)	
	)	
Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area	)	

REPLY TO OPPOSITION
UNITED STATES TELEPHONE ASSOCIATION

Pursuant to Section 1.429 of the Commission's rules, the United States Telephone Association ("USTA") respectfully submits this reply in response to Opposition to USTA's original Petition for Reconsideration requesting that the Federal Communications Commission reconsider the rules adopted within its Second Report and Order[1] -- and subsequently modified in an Order on Reconsideration executed pursuant to the Commission's own motion[2] -- in the

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1 Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area and Policy and Rules Concerning the Interstate, Interexchange Marketplace, Second Report and Order and Third Report and Order, CC Docket Nos. 96-149, 96-61, FCC 97-142 (released April 18, 1997) (Classification of LEC Long Distance Service Report and Order).

2 Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area and Policy and Rules Concerning the Interstate, Interexchange Marketplace, Order on Reconsideration, CC Docket Nos. 96-149, 96-61, FCC 97-229 (released

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above-captioned proceeding. USTA is the major trade association of the local exchange carrier ("LEC") industry, with over 1,000 members.

I. Summation Of Opposition

The crux of the argument made by parties opposing USTA's Petition for Reconsideration centers on the contention that adopting USTA's proposal would allow incumbent LECs ("ILECs") to misallocate costs, and that this in turn would harm the interexchange market. The price squeeze scenario is a subset of the cost misallocation issue.[3] The primary allegation of these parties is that ILECs would use cost misallocation to subsidize their interexchange operations and undercut competing interexchange carriers ("IXCs"). Although this notion has a certain amount of appeal on the surface, further reflection reveals that the argument is fatally flawed.

The argument is flawed because its materiality depends on assuming that the act of undercutting the IXCs is itself the goal, when in fact economic logic dictates that undercutting cannot be anything but a means to a greater end. Economic logic dictates that this end must be the elimination of competing IXCs from the interexchange market. Because this goal must be the end for cost misallocation, and this end cannot be achieved, then the notion that ILECs will purposely misallocate costs to harm the IXCs is incorrect on its face.

June 27, 1997).

[3] The remaining issue of ILECs providing discriminatory access is avoided by the opposing parties. References to discriminatory access by the opposing parties are vague. The only specific incidence of alleged anti-competitive behavior cited by the opposing parties deals with the completely unrelated matter of primary interexchange carrier freezes. (Opposition of MCI at p. 15, filed September 8, 1997) Given this apparent concession that discriminatory access is not a problem, USTA will limit its remarks to addressing the cost misallocation issue, of which price squeezes are a subset.

II. Arguments That ILECs Have The Ability To Misallocate Costs Avoid Answering The More Important Question Of Whether ILECs Have The Incentive To Misallocate Costs In The First Place.

In considering the allegation that ILECs will purposely misallocate costs to support their interexchange service, the question of "why?" must be asked and answered. By subsidizing its interexchange operations, an ILEC is making the conscious decision to decrease its profit level in its local exchange operations in order to compete successfully with the IXCs. No ILEC would undertake such an action if it felt that it were able to compete successfully in the interexchange market without having to sacrifice profits in its local exchange operations.[4] Therefore, since cost misallocation must be a necessity in order to compete successfully, one must conclude that ILEC interexchange service in competition with IXCs is unprofitable. If it were profitable, there would be no need to subsidize the service.

Since ILEC interexchange service in competition with IXCs is unprofitable, the obvious question of why an ILEC would even choose to offer interexchange service arises. No ILEC -- or any other firm for that matter -- would enter a perpetually unprofitable business. Firms entering new lines of service expect initial losses to continue for several quarters or even years until a sufficient customer base is established and sustained. Although business success is never guaranteed, no firm would enter a business that was guaranteed to be unprofitable forever. In the case of ILEC cost misallocation, subsidizing interexchange service makes sense only if the firm

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[4] The counter-argument that rate-of-return ILECs have the incentive to misallocate costs to increase their rate base and thereby increase their local rates ignores the presence of state public utility commissions, which take a keen and vigilant interest in observing the development of local rates. Moreover, regardless of the rate at which competition is developing in the local market, it is, nonetheless, developing. Any action that unnecessarily produces higher local rates is not productive with respect to an ILEC's strategic business goals.

has some reasonable assurance that the unprofitableness of interexchange service will eventually disappear. Otherwise, the ILEC is getting less return for its investment than if it would never have entered the business in the first place. The only way for the unprofitableness to disappear is the elimination of the competing IXCs so that the ILEC can restore its former profit margins in its local exchange operations. It seems safe to say that no party in this proceeding realistically believes that any ILEC interexchange affiliate will be able to drive its competing IXCs out of the market. Doing so would require the successive vanquishment of AT&T, BT/MCI, Sprint, and WorldCom. Like a mythical hydra, beyond those four IXCs stand hundreds of others that would readily step into their place. The verity of this statement is confirmed by the Commission's own findings with respect to the lack of market power possessed by ILEC interexchange affiliates.[5]

MCI makes the claim that USTA's proposal would allow ILECs to misallocate costs, thereby harming interexchange competition. However, MCI fails to take its argument to its logical conclusion. MCI answers the question of "what?" but does not then go on to ask "why?" It does not do this because the answer to that question is completely at odds with marketplace realities, thereby illuminating the patent erroneousness of its original assertion about what ILECs would do if the Commission adopted USTA's proposal. ILECs have no incentive to misallocate costs from their interexchange operations to their local operations because doing so only decreases profit margins for the indefinite period of time it would take the ILEC to drive the competing IXCs out of the market.[6] No firm would engage in cost misallocation and reduced

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[5] Classification of LEC Long Distance Service Report and Order at ¶7.

[6] For this discussion, market definition does not matter. Even in a point-to-point market, at least three out of four largest IXCs would likely be represented. Because driving them out of the market would take time, other smaller IXCs would have time to take their place as they exited. Even point-to-point markets are dynamic and subject to change, so the notion that an

profit margins simply for the sheer sake of it. There must be a larger goal to be achieved. In this case -- driving competing IXCs out of the market -- the goal is unobtainable.

III. The Price Squeeze Scenario Is Flawed For The Same Reasons As The Assertion About ILECs Having An Incentive To Misallocate Costs.

For identical reasons, MCI's chestnut about excessive access charges facilitating price squeezes also does not hold any weight.[7] Putting aside for the moment all of the other reasons why the notion of a price squeeze is a purely theoretical creature,[8] a price squeeze has no practical appeal to an ILEC because it is a means to an unobtainable end. MCI's argument focuses on the mechanics of how a price squeeze might be attempted, but again ignores the underlying question of why an ILEC would attempt one in the first place.

Even assuming *arguendo* MCI's premise that access charges constitute an internal subsidy for ILECs is correct, there still does not exist a motivating factor for the ILEC to use it as such. The price squeeze scenario becomes plausible only if the ILEC finds the provision of interexchange service to be unprofitable. The ILEC would have no need to sacrifice the profit margin of its "excessive" access charges if it was already able to provide interexchange service profitably. If the service truly is unprofitable, then the price squeeze scenario becomes a consideration only if the ILEC has reason to believe that it will drive the competing IXCs out of

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ILEC could drive an IXC out of its local market without having to drive it out of business is irrelevant because it assumes a static level of market entry, specifically zero. The ILEC would still be faced with an open-ended period of reduced profit margins.

7 Opposition of MCI at pp. 13-14 (filed September 8, 1997).

8 See USTA Petition for Reconsideration at pp. 9-11 (filed August 4, 1997).

the market. This has already been shown to be an impossibility because ILECs lack the market power necessary to do so. The price squeeze scenario rests on the assumption that the ILEC, through cost misallocation, will be able to turn what must by definition be an unprofitable business venture into a profitable one, a goal that can only be realized by the elimination of the IXCs. This assumption is preposterous, and the Commission should recognize as much by looking beyond the surface of the anti-competitive mechanics MCI alleges and examining the bankrupt nature of the premise upon which the mechanics rest.

IV. The Opposing Parties Do Not Explain What Additional Accounting Safeguards Are Gained Through The Fifth Report And Order That Are Not Also Gained And Strengthened Through Part 64.

MCI's argument against USTA's proposal to update the Fifth Report and Order safeguards by bringing them in line with Part 64 seems counter-intuitive. MCI makes the statement that the Part 64 cost allocation rules do not work.[9] MCI asserts that because Part 64 does not work, the Commission must continue to maintain the Fifth Report and Order requirement of separate books of account. Since the Fifth Report and Order, the Commission has painstakingly devoted enormous amounts of time and resources toward fine-tuning its cost allocation procedures. The Fifth Report and Order requirement of "separate books of account" provides far less guidance on cost allocation than Part 64. It is unclear why MCI apparently believes that the Fifth Report and Order provides greater assurances against cost misallocation than Part 64.

For its part, TRA quotes the Commission's Classification of LEC Long Distance Service

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[9] Opposition of MCI at pp. 7-8 (filed September 8, 1997).

Report and Order asserting that "absent appropriate and effective regulation, independent LECs have the ability and incentive to misallocate costs from their in-region, interstate services to their monopoly local exchange and exchange access services within their local service region."[10] Again, this begs the question of why the phrase "separate books of account" provides greater protection against cost misallocation than all of the various proceedings the Commission has undertaken in refining Part 64.

V. The Cost Misallocation Incident Cited By MCI Is Proof-Positive That The Commission's Part 64 Accounting Procedures Work.

For evidence of cost misallocation, MCI cites misallocated lobbying costs by the Bell Operating Companies ("BOCs"),[11] a legitimate instance of improper accounting procedures which was detected and rectified. The Commission's accounting rules are designed to deter *and* detect. MCI attempts to portray the Commission's entire accounting regime as a failure because it successfully fulfills *both* of its design functions, instead of just one. Without diminishing the gravity of the instance MCI cites, it would be appropriate to put bring some proper perspective to the matter. MCI cites the Commission's figure of $116.5 million of misallocated costs from 1988 through 1991. In that same time frame, the BOCs had operating expenses of $196.8 BILLION.[12] The amount misallocated corresponds to *six hundredths of one percent* of the operating costs that

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10 Opposition of TRA at p. 6 (filed September 8, 1997). See, also, Classification of LEC Long Distance Service Report and Order at ¶159.

11 Opposition of MCI at pp. 7-8.

12 USTA annual publication, Statistics of the Local Exchange Carriers, years 1989-1992.

were allocated between 1988 and 1991. Moreover, as a result of that incident, the auditing requirements and accounting procedures of the BOCs have been tightened to prevent a recurrence.[13] That the Commission's accounting procedures were able to detect and correct an error that small is manifestly indicative of their effectiveness.

The success of Part 64 is not premised on the need for different operations to be legally distinct and separate from one another. Neither the Commission nor any of the commenting parties opposing USTA has explained or demonstrated *any* additional competitive protections resulting from requiring independent LEC interexchange affiliates to be legally separate entities. USTA would again urge the Commission to reconsider its decision.

CONCLUSION

USTA is asking the Commission to update the Fifth Report and Order requirements by bringing them into line with and incorporating them into the framework of Part 64. If the Commission had established Part 64 prior to the Fifth Report and Order, that Order would have had two requirements instead of three. The requirements about separate books of account and taking tariffed services at tariffed rates are both addressed by Part 64. The prohibition on joint ownership of switching and transmission facilities protects against discriminatory access, something which the Equal Access provisions initially complemented but have long since superseded.[14]

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13 Commission Releases Summary of Lobbying Costs Audit Findings, Report No. CC 95-65 (released October 26, 1995).

14 MTS and WATS Market Structure Phase III, Report and Order, CC Docket No. 78-72, Phase III, 100 FCC 2d 860 (1985) ("Equal Access Order") at p. 875, ¶ 48. USTA would

Contrary to what those parties opposing USTA's petition assert, the newly instituted requirement that ILEC interexchange affiliates must be separate legal entities is a new issue warranting reconsideration. The issue was never raised properly for comment and its imposition contravenes Congressional intent.[15] None of the parties opposing USTA's petition have been able to provide a logical foundation supporting their theoretical assertions, let alone produce any evidence substantiating such assertions. Nor have they shown how continuing the Fifth Report and Order affords a greater degree of competitive safeguards against cost misallocation than the modern and constantly revised Part 64 rules.

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again note that none of the parties opposing USTA's petition raise discriminatory access as an issue.

[15] See Letter to The Honorable Reed E. Hundt, Chairman, dated June 25, 1997, signed by Representatives Tauzin, Oxley, Dingell, Boucher *et al.* MCI's assertion that this letter "hardly qualifies as even the weakest form of legislative history" (Opposition of MCI at p. 5, filed September 8, 1997) is disingenuous. The lack of legislative history in the Conference Report accompanying the Telecommunications Act of 1996 is due to the fact that there is no statutory language addressing independent ILEC interexchange affiliates anywhere in the Act. The reason that there is no statutory language is because despite having ample time to consider the matter, Congress did not deem it necessary to require independent ILECs to create separate legal entities to provide a service they have been providing for years without significant incident.

For this and the previously stated reasons, the Commission should reconsider the rules adopted by it in its Classification of LEC Long Distance Service Report and Order in favor of those proposed by USTA.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, Carl McFadgion, do certify that on September 23, 1997 copies of the Reply to Opposition of the United States Telephone Association were either hand-delivered, or deposited in the U.S. Mail, first-class, postage prepaid to the person on the attached service list.

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