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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
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In the Matter of	)	
LCI International Telecom Corp.	)	CC Docket No. 98-5
Petition for Expedited Declaratory Ruling	)	

COMMENTS OF THE AD HOC TELECOMMUNICATIONS USERS COMMITTEE

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Summary

In accordance with LCI's petition and the improvement thereto suggested herein, the Commission should establish a "fast track" for RBOC entry into the in-region long distance market. The Ad Hoc Telecommunications Users Committee suggests that the Commission (1) allow NetCo to recover the so-called "gap" between the embedded cost and incremental cost of RBOC exchange plant, and (2) permit ServCo to price flexibly and maximize its profits if the RBOC elects to restructure and meet the other requirements set forth in LCI's petition. This change would increase the chances of RBOCs opting for the "fast track" to enter into the in-region long distance market.

The RBOCs will, however, likely reject the "fast track" proposal because at this time they perceive little to gain from the restructuring that the "fast track" approach would require. Pressure on the Commission to grant RBOC petitions to enter the in-region long distance market appears to growing stronger. If, however, the Commission resists such pressure and continues to analyze rigorously RBOC section 271 applications and creates other incentives, (such as promptly investigating the incremental cost of providing interstate access service), RBOCs will have an incentive to restructure pursuant to the LCI "fast track" proposal – particularly if the Commission adopts a "fast track" approach that constructively deals with the so-called "gap" problem.

In light of the RBOCs prosecution of appellate efforts that have undermined the potential efficacy of the Commission's efforts to catalyze the growth of local exchange and access service competition, the Commission

should try another approach. LCI's "fast track" approach, along with other incentives that the Commission can create, could contribute substantially to more competition in the local exchange and access service market. Without a new approach, such as that suggested by LCI, the prospects for widespread effective and lasting competition in the local exchange and access service market – competition that would serve all consumers -- are bleak.

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Comments of
Ad Hoc Telecommunications Users Committee

The Ad Hoc Telecommunications Users Committee (Ad Hoc or the Committee) hereby submits its comments on the January 22, 1998 Petition of LCI International Telecom Corp. for Expedited Declaratory Rulings. LCI's petition proposes a "fast track" plan for Regional Bell Operating Company (RBOC) entry into the in-region long distance telecommunications market. In sum, LCI seeks a Commission ruling that a rebuttable presumption would exist that RBOCs have satisfied the requirements of section 271 of the Communications Act, as amended, if they voluntarily fully separate their retail and wholesale activities and meet other requirements proposed in LCI's petition.

Ad Hoc strongly supports regulatory policies that will promote the development of effective and lasting competition in all parts of the telecommunications market. The Committee supports neither long distance or local exchange carriers; it supports efforts to increase the level of competition in all segments of the telecommunications market, local as well long distance. LCI's proposal, particularly given the decisions of the United States Court of Appeals for the Eighth Circuit reversing key portions of the Commission's Expanded Interconnection decision, could do much to create such competition in the local exchange and access service market. Ad Hoc, however, herein proposes a significant modification of LCI's proposal – a modification that may increase the odds of the RBOCs opting to restructure their operations in accordance with LCI's proposal. Absent greater incentives than seem inherent in LCI's proposal, Ad Hoc suspects that the RBOCs will not opt to restructure to gain fast track entry into the in-region long distance market.

I. A MATTER OF INCENTIVES

The pressure on the Commission, particularly from Capitol Hill, to approve RBOC entry into the in-region long distance market seems to be growing. Some would have the Commission authorize RBOC entry into the in-region long distance market without regard to the level of competition in the relevant local exchange and access service market. If the RBOCs conclude that the Commission, under pressure, will grant their 271 applications without a showing of effective competition in the local exchange and access service markets, and otherwise afford them the regulatory relief that they seek (such as pricing flexibility, full recovery of embedded accounting costs, and no requirement to make unbundled network functionalities available to non-carriers), there would be little reason for them to select LCI's fast track approach. If the Commission wishes to increase the odds of RBOCs selecting the fast track route to entry into the in-region long distance market, it must resist mounting pressures and otherwise adopt regulatory policies and requirements that will not prematurely deregulate incumbent local exchange carrier pricing and that will create the best environment for maximizing consumer choice through multiple sources of supply. The key to RBOC acceptance of LCI's fast track approach is the right package of incentives. Ad Hoc herein proposes an additional very positive and powerful incentive. The Commission, however, must accept the responsibility to create the right *package* of incentives coupled with the determination to fully apply all of the requirements of Section 271 without yielding to pressure to look the other way. If it does not do so, the prospects for competition developing in the local exchange and access service market in the foreseeable future are bleak.

More than two years have elapsed since the enactment of the *Telecommunications Act of 1996* ("Act"), yet the core vision of this landmark legislation -- increased competition in the provision of local telephone services -- is not much further along than it was on the date of enactment. There are a number of possible explanations for the frustratingly slow pace of competitive entry, but in the end much of the responsibility lies with the incumbent local exchange carriers' continuing resistance to regulatory efforts aimed at opening their markets on terms that will truly facilitate the development of competition.

The ILEC's response is hardly surprising. Indeed, arguing before the New Zealand Ministry of Commerce in its capacity as a CLEC, BellSouth succinctly recounted the incentives confronting the incumbent monopolist, noting that an ILEC "can and will rationally use interconnection negotiations to delay and restrict the benefits of competition ... A dominant incumbent can limit both the scale and scope of its competitors, raising their costs and restricting their product offerings. In addition, it can divert or delay competition and innovation to protect its current revenues."[1] In fact, as BellSouth points out, not only is it rational for an incumbent provider to behave in a manner that protects its market position, it is the fiduciary responsibility of an ILEC's directors to adopt such tactics absent any countervailing considerations (such as long distance entry).[2]

Section 271 offers BOCs the opportunity to reenter the interLATA long distance market, a market from which they have been barred, provided that they satisfy a list of specific pro-competitive conditions. The theory is clear and straightforward: When the RBOCs were excluded from the long distance business in the 1984 break-up of the former Bell system, the purpose of this *structural* remedy was to prevent these companies from leveraging their monopoly in the local service market into the adjacent and potentially competitive long distance market. The theory underlying the 1996 Telecom Act is that if there is sufficient competition in the local exchange market, the RBOCs will be unable as an economic matter to monopolize the adjacent long distance market,

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1 See *Regulation of Access to Vertically-Integrated Natural Monopolies*, discussion paper of BellSouth New Zealand, September, 1995, at 2.

2 Hubbard and Lehr go on (at 2) to report the BellSouth discussion paper as arguing that it is rational for an incumbent:

> "to exploit the regulatory regime to the greatest possible extent without exposing itself to the threat of intervention or adverse changes to the regime. In fact, the directors of the dominant incumbent have a fiduciary duty to seek to extract the highest rents available to it as a result of its business position (as does any other profit-maximizing firm).....It has very powerful incentives to include monopoly rents in the price of complementary network services in order to perpetuate and increase its monopoly profits. It similarly has powerful incentives to reduce the ability of its competitors to claim market share."

because they will no longer operate as a monopoly in the local service business. For the theory to work, it is essential that actual, not theoretical, competition come to exist on a widespread basis in local services.

In the last year, several BOCs have filed Section 271 applications with the Commission, and more are to come. To date, the Commission has not granted any of the Section 271 applications.[3] Eventually, though, it is likely that one will succeed, and the terms on which the application is approved will set the standard for approval for the remainder to follow. It seems that the RBOCs hope to enter the in-region long distance market by doing no more than the barest minimum that the Commission requires with respect to facilitating the use of their networks and services to support the growth of competition in the local exchange and access service markets. This strategy is neither evil nor mysterious. It simply is driven by the RBOCs' business incentives. Those incentives, however, are not consistent with the goals of the Telecommunications Act of 1996.

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3 *Application of Ameritech Michigan Pursuant to Section 271 of the Communications Act of 1934, as amended, to Provide In-region, InterLATA Services in Michigan,* CC Docket No. 97-137, Memorandum Opinion and Order, FCC 97-298 (rel. August 19, 1997); *Application of SBC Communications Inc. Pursuant to Section 271 of the Communications Act of 1934, as amended, to Provide In-region, InterLATA Services In Oklahoma,* CC Docket No. 97-121, Memorandum Opinion And Order, FCC 97-228 (rel. June 26, 1997); *Application of BellSouth Corporation, et al., Pursuant to Section 271 of Communications Act of 1934, as amended, to Provide In-region, InterLATA Services in South Carolina*, CC Docket No. 97-208, Memorandum Opinion and Order, FCC 97-418 (rel. Dec. 24, 1997); *Application of BellSouth Corporations, et al., Pursuant to Section 271 of Communications Act of 1934, as amended, to Provide In-region, InterLATA Service in Louisiana,* CC Docket 97-231, Memorandum Opinion and Order (rel. Feb. 4, 1998)

II. IN THE WAKE OF APPELLATE REVERSALS, PROSPECTS FOR COMPETITION ARE POOR.

Competition in the local exchange and access service market is at present very limited. Certainly, competition in this market exists in niches. But prospects for the rapid growth of wide spread competition in the local exchange and access service market are at present poor.

The '96 Telecom Act contemplates three distinct routes to local exchange and access service competition — facilities-based, unbundled network elements (UNEs), and total service resale. There is no preference or bias in the Act as to which of these three is to be encouraged, and certainly no indication that any one form of entry is to be encouraged to the exclusion of others. In framing the "96 Telecom Act, however, Congress was cognizant of the fundamental limits of facilities-based competition, particularly in the near term. It addressed this limitation by adopting a paradigm in which effective competition on a geographically widespread basis could develop, permitting entrants to have full access to the existing ILEC infrastructure on an unbundled basis at rates based upon forward-looking costs. Inasmuch as the incumbent LECs have committed in excess of $200-billion in ratepayer-supplied funds to acquire and to evolve their infrastructures operating for nearly a century as government-protected monopolies, capital requirements alone make it unlikely that significant facilities-based competition will arrive any time soon. Indeed, there may well be places and conditions under which only one provider will ultimately be supported in the market, in which case the incumbent (or its descendent) will necessarily be the only provider of services that uses its own facilities. For competition to develop ubiquitously in all geographic areas of the country, it is essential that entrants have the ability to obtain the necessary interconnections and unbundled network elements from ILECs at rates that are based on marginal costs, no matter where the entrant chooses to operate. Less will undermine the substantial pro-competitive potential of the '96 Telecom Act.

But less seems to be exactly what consumers will get in light of the decisions of the United States Court of Appeals for the Eighth Circuit. The court has held, *inter alia,* that (1) the Commission does not have jurisdiction to require that state authorities use a marginal cost standard to set rates for UNEs and (2) local exchange carriers are not required to reassemble UNEs purchased by would be competitors.[4] Although the Eighth Circuit's orders will be reviewed be the Supreme Court, the outcome of that litigation, of course, is far from certain. The prudent course would be for the Commission to take steps to encourage the RBOCs to cease resisting efforts to bring more competition to the local exchange and access service market and the long distance market – competition that would benefit all consumers of telecommunications services.

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4 *Implementation of the local Competition Provisions of the Telecommunications Act of 1996,* First Report and Order, CC Docket No. 96-98, 11 FCC Rcd. 15499 (1996), *aff'd in part and rev'd in part, sub nom. Competitive Telecommunications Ass'n. v. FCC,* 117 F.3d 1068 (8th Cir. 1997); *Iowa Util. Bd. v. FCC, as amended on rehearing* Oct. 14, 1997, 120 F.3d 753 (8th Cir. 1997), *cert. pending.*

III. THE LCI PETITION

LCI has proposed a plan that would specifically modify the RBOCs' incentives to block and frustrate competitive entry. LCI proposes that the underlying network and associated network functionalities be separated from the ILECs' retail service provisioning operations, and that the ILECs' own retail operations, along with all of its rivals', would be afforded equivalent access, on the same terms and conditions and at the same price levels, as the RBOCs' own retail operations. While not calling for outright divestiture of the wholesale from the retail operations, LCI does suggest that the two entities have different and non-overlapping slates of directors and officers, and that the retail operation ("ServeCo") have substantial minority ownership. The goal of these requirements is to make the network service entity ("NetCo") largely indifferent as to whom it furnishes underlying services for resale. Under LCI's plan, the presence of significant minority ownership of ServeCo would eliminate any incentive that NetCo might have to afford its affiliate preferential treatment.

The LCI plan would be offered on a voluntary basis to RBOCs, but if accepted would create a rebuttable presumption that the RBOCs had complied with Section 271 in all material respects, and that FCC action on the their interLATA applications would be likely.

Under the model proposed by LCI, NetCo would furnish access to the ILEC's network, in the form of UNEs, at prices set equal to TELRIC. The same UNE rates would apply to the affiliate ServeCo as to nonaffiliated CLECs.

ServeCo would have precisely the same type of interconnection access as any nonaffiliated competitor, including co-location opportunities that are fully equivalent to those that would apply to the affiliate retail entity.[5] In short, ServeCo would possess no incumbency advantages that were not also available to a nonaffiliated CLEC on the same terms and conditions.

In exchange for this "equal access" that would be provided by NetCo to affiliated and nonaffiliated retailers alike, ServeCo or another HoldCo entity would be afforded the opportunity to enter the long distance business. The basic theory of LCI's petition appears to be fully consistent with the objectives of the '96 Telecom Act: If ServeCo is stripped both of its ability to apply and exploit the NetCo infrastructure monopoly to dominate the adjacent long distance market, then the potential for anticompetitive acts by ServeCo would be diminished, or perhaps eliminated altogether. The effect, under LCI's vision, would be to create the same degree of indifference on the part of NetCo as to whether it deals with its partial affiliate or a nonaffiliated CLEC - just as the MFJ created indifference on the part of the RBOCs as to whether they furnished switched access to AT&T or any other long distance provider. The MFJ indifference was accomplished through outright structural separation; the indifference that would be created by the LCI framework would be achieved by affording ServeCo with a sufficient

5 For example, if non-affiliated CLECs are required to confine their co-located facilities to a "cage" in the BOC's central office, then ServeCo would presumably face a similar requirement; conversely, if ServeCo is not required to fence off its equipment from that of NetCo, then other CLECs could not be forced to do so as a precondition for location.

degree of minority ownership, with separate officers and directors whose compensation was based solely upon their respective entity's (NetCo's or ServeCo's) performance, so as to eliminate any incentive for discriminatory self-dealing. Indeed, even the ServeCo company name could not be the same as that used by NetCo or HoldCo; as LCI sees it, NetCo's monopoly and incumbency positions must be of no benefit to ServeCo in its efforts to compete with CLECs.

Stripped of its incentives to hold back on making its proprietary network resources available on a nondiscriminatory basis to competitors, NetCo would have an incentive to open its network to all. If LCI's vision is accurate, the effect would be similar to that of the MFJ in opening up the long distance market to real and effective competition.

IV. IMPROVEMENTS TO THE LCI MODEL

While sound in its overall framework, LCI's petition does not fully address some important matters. For one, long distance entry cannot be permitted merely because of the restructuring; operational changes and modifications to the incumbent's OSS will be necessary as a precondition for opening up the long distance market. To work as LCI envisions it, there can be *no benefit whatsoever* available to ServeCo as a result of its affiliation with NetCo.

The other major flaw in LCI's proposal is that it makes no allowance for the fact that by requiring NetCo to set UNE rates at TELRIC and by expressly precluding it from exploiting its embedded infrastructure for its own competitive benefit, NetCo will not have an opportunity to recover its embedded rate base investment.[6] A solution to this so-called "gap" problem likely will need to be developed in order for LCI's proposal to be acceptable to an RBOC.

Although RBOCs and other ILEC have argued for several years that they must be "made whole" for investments made prior to the onset of competition, those arguments are rather vacant under a regulatory paradigm in which incumbent LECs are permitted to exploit their embedded infrastructure and organizational resources to expand their markets into competitive areas and to increase their profits overall. Indeed, under the price cap regime most recently established by the Commission in its May, 1997 order in CC Docket 94-1, RBOCs and other price cap ILECs are permitted to increase earnings without limit, while remaining protected against even a modest earnings erosion of as little as 100 basis points below the authorized rate of return.[7]

In a proposal presented to the Commission, the Ad Hoc Committee suggested that ILECs seeking recovery of so-called "stranded" or "legacy" costs

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6 As demonstrated by ILEX investors' persistent willingness to value ILEC shares at multiple of book value, ILECs clearly possess the ability to more than recover their embedded investment through exploitation of their overall (tangible and intangible) asset base even where rates for certain essential services and UNEs are set below embedded accounting cost. Selwyn, Lee L. and Kravtin, Patricia, D., *Analysis of Incumbent LEC Embedded Investment*, May 30, 1996, filed as Attachment C to AT&T Reply Comments in CC Docket 96-98 ("Selwyn and Kravtin").

7. *Price Cap Performance Review for Local Exchange Carriers, Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262,* 12 FCC Rcd 16642, 16691, 16699-16703, *petitions for recon. pending; appeals pending sub nom. US Tel. Assn v. FCC,* D.C. Cir. Case No. 97-1469.

be confronted with a choice of regulatory treatments.[8] Under the "make whole/make money" choice suggested by Ad Hoc, ILECs could elect either (1) full recovery, through securitized amortization, of the "gap" between embedded and forward-looking costs of their embedded plant, but would not be permitted to exploit their embedded infrastructure for competitive gain or to increase earnings materially in excess of the authorized level; or (2) forego any "by right" recovery of stranded costs, but be permitted to exploit their embedded plant and to earn excess profits subject to making essential network resources available to competitors at TELRIC rates. ILECs electing the second "make money" alternative would not be permitted to claim confiscation of their property because they could have elected to be made whole, but ILECs who do elect to be made whole would, in effect, be forced to return to a price cap regime in which earnings in excess of the authorized level would be strictly limited.

Under the corporate restructuring envisioned by LCI, NetCo would own the network resources and would be required to offer these to the ServeCo affiliate and to others at TELRIC-based rates; NetCo would not be permitted to exploit its monopoly controls of the underlying infrastructure or to exact monopoly rents from any of the (affiliated or nonaffiliated) carriers with whom it deals. Not mentioned in the LCI proposal, however, is the consequence that by charging TELRIC-based rates NetCo might not be able to recover its embedded

8. *Access Charge Reform,* CC Docket No. 96-262, Ad Hoc Telecommunications Users Committee, Comments, at 65-67, Jan. 29, 1997.

investment, and yet would be precluded from exploiting those network resources for its own competitive gain. ServeCo would not be subject to such restrictions on earnings, but would nevertheless be constrained by nonaffiliated retail competitors' prices, assuming that the LCI model is functioning as envisioned. Hence, without addressing the issue of recovery of the "gap," the electing RBOC could be forced to absorb these costs without any opportunity for their recovery.

Since the LCI proposal is offered as one that may be elected as an optional regulatory paradigm by an RBOC, there is no confiscation issue *per se*. However, without either the opportunity to be made whole for, or to exploit and increase earnings on, the embedded infrastructure, it seems unlikely that the LCI proposal would be elected. Given current circumstances, RBOCs would have little apparent incentive to opt for the LCI fast track approach. Ad Hoc believes that the LCI plan could be made more palatable if, in addition to addressing the matter of long distance entry, it also dealt with the issue of stranded costs – an issue that the Commission must deal with in connection with universal service funding and a pending petition that interstate access service price cap indices be reinitialized to reflect forward looking incremental costs.

Ad Hoc notes, however, that by its recognition of the potential presence of a "stranded cost" problem it does not concede that the "gap" is anything close to the magnitude being claimed by ILECs. In a study undertaken by Patricia D. Kravtin of Economics and Technology, Inc. (ETI) for AT&T,[9] it was demonstrated

9 Selwyn and Kravtin.

that the overall magnitude of the "gap" was far smaller than the ILECs' claim. In particular, ILECs have no claim for entitlement to recover costs that were incurred in pursuit of competitive or other optional services that fall outside of any historic "obligation to serve," and for those costs to which the ILEC may be theoretically entitled to recovery, those instances where the forward-looking cost is below embedded cost must be offset by cases in which forward-looking cost is greater than embedded, such as for the construction of pole lines, conduits, copper loops, and for the placement of buried cables. In suggesting that treatment of the so-called "gap" within the scope of an LCI-type restructuring plan, Ad Hoc does not concede that any actual gap exists or that its magnitude is anything close to that being suggested by ILECs.

Any positive gap that may exist and to which the ILEC may be entitled to recovery can be addressed through a process known as securitization. Under this technique, which is currently being used by several states as part of electric utility restructuring, the gap, once determined, would be amortized through the issuance of bonded debt at prime corporate, or perhaps even tax-exempt, rates. Because recovery would be effectively guaranteed, this special treatment of these amounts would be separate and apart from the remaining capital structure of the incumbent; indeed, one ancillary benefit would be to *reduce* the incumbent's cost of capital, since the risk of loss of stranded costs would have been eliminated.

The amortization would occur over an eight-year period, the same as that used by the Commission to write off inside wire between 1983 and 1991.[10] These amounts would be added to the TELRIC-based rates charged by NetCo as an across-the-board surcharge, and would be borne on a competitively-neutral basis by all users of NetCo facilities.

V. CONCLUSION

The Commission should grant LCI's petition, as modified by Ad Hoc's "make whole/make money" proposal, and provide a "fast track" for RBOC entry into the in-region long distance market. Without a package of incentives that effectively encourages RBOCs to choose the "fast track", this Commission will waste the best opportunity it likely will have to bring effective and lasting competition to the local exchange and access service market.

Respectfully submitted,

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10 *Detariffing the Installation and Maintenance of Inside Wiring*, CC Docket No. 79-105, First Report and Order, 85 FCC 2d 818 (1981).

Certificate of Service

I, Andrew Baer, hereby certify that true and correct copies of the preceding Comments of the Ad Hoc Telecommunications Users Committee in the Matter of LCI International Telecom Corp. Petition for Expedited Declaratory Ruling pursuant to the Commission's January 26, 1998 request for comments regarding CC Docket No. 98-5 were served this 23rd day of March, 1998 via hand delivery upon the following parties:

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