IP transport that threaten to cannibalize the BOCs' retail services; to increase the price of these loops above economic levels; and to use their loop revenues to cross-subsidize the more competitive elements of their businesses.

Under LCI's proposal, the loop network would be separated from the BOC's retail operations, but it would still be combined (in the "NetCo" entity) with other elements of the network that are more competitive, and with the marketing and sale of wholesale bundled telecommunications services. This structure would, to a large extent, preserve the existing conflict of interest within NetCo. This entity would still have an interest in cross-subsidizing its switching, transport, and other competitive service elements with revenues from loops; and therefore would still have a motive, as well as the ability, to inflate the price of loops and restrict competitive access to the loop bottleneck. In addition, as a marketer of bundled wholesale services, NetCo would have an interest in preventing, delaying, or limiting the use of its loops to provide new services that might bypass or otherwise undermine its sales of wholesale services, such as IP transport services.

For these reasons, the BOC loop networks should be structurally separated from the more competitive elements of the network. The LCI proposal fails to achieve this, and therefore should not be adopted in its present form.

C. Structural Separation Should Focus on Isolating the BOCs from Control of the Bottleneck Loops, Not from Retail Functions

The structural separation proposed by LCI focuses primarily on reducing the BOCs' control over retail operations (both in the local and the long-distance markets). LCI proposes that ServeCo, the retail entity under its plan, should be at least partially divested by the BOC. This proposal would limit (but not eliminate) the BOC's ability to influence ServeCo's pricing and marketing decisions in the

retail markets, since the ServeCo management would be responsible to other shareholders besides the BOC.

LCI's proposal, although again a step in the right direction, seems to miss the mark in this respect. The BOC conflict-of-interest problem is not caused by the BOCs' ability to market services at the retail level, but rather by their control over bottleneck loop facilities. Limiting the BOCs' control over ServeCo does little if anything to lessen their ability and incentive to abuse their control over the bottleneck loop network. Because the BOC would own 60% of ServeCo, it would still have an interest in giving ServeCo every possible advantage over its rivals in the retail market; and, because it would own 100% of NetCo, it would have many opportunities to extend such advantages to its affiliate.

The LCI proposal would create obvious incentives for overt discrimination by NetCo in favor of ServeCo in prices, quality of service, responsiveness, access to information, and the like.* This type of abuse might possibly be detected by rivals and corrected by regulatory oversight, although the price of the continual regulatory scrutiny and enforcement necessary to provide effective policing of discrimination would be far from negligible.

Moreover, NetCo may be able to promote the interests of ServeCo in various ways that are not facially discriminatory. For example, if ServeCo is not interested in providing high-bandwidth services in its territory, or particular portions of its territory, NetCo could refuse to provide *any customer* with conditioned loops capable of transmitting high bandwidths. This refusal would not be overtly discriminatory, but nonetheless would serve to protect ServeCo against competitive incursions by rival companies. Similarly, since competitive threats to ServeCo are likely to be concentrated in urban markets in the first instance, NetCo would have an incentive to maintain geographically averaged unbundled loop rates. By keeping loop rates artificially low in rural areas and

artificially high in urban areas, NetCo could help to discourage entry into the more attractive urban markets while allowing ServeCo's rural services to remain profitable. The only way to eliminate this incentive is to eliminate the ability of NetCo or its owner to benefit from the market success of ServeCo.

III. The Commission Should Explore Alternative Approaches to Structural Separation

As shown in the preceding sections, the issues raised by LCI are both valid and crucial to the achievement of a competitive telecommunications market. However, the remedies proposed by LCI do not go far enough to resolve the problems it has identified. The Commission has essentially two choices under these circumstances. It can dismiss the LCI petition as insufficient and allow the abuses identified in that petition to continue unchecked; or it can broaden the scope of this proceeding to include consideration of remedies going beyond LCI's proposal, considering the substantial public interest benefits achievable if the conflict of interest problem can be solved. Obviously, Level 3 favors the latter option.

Elimination of the BOCs' (and other LECs') loop bottleneck would yield major public benefits to the public. If control of the loop could be separated effectively from the BOCs' competitive interests, there would be no incentive to limit competitive access to these facilities or to price them in a discriminatory or strategic manner. (Of course, regulation of price levels would continue to be needed to prevent monopoly pricing, as LCI recognizes.) Under these conditions, the competitive market can be expected to develop a wide range of innovative new telecommunications services that will rapidly advance the options available to both residential and small business customers. Although telecommunications switching has advanced at much the same rate as computer technology, since both are based on integrated circuits and microprocessors, and fiber optic technology has advanced at a similarly fast

pace in recent years, fairly little of the benefits of these productivity gains has been realized by residential and small business users. Opening up the loop bottleneck would allow these benefits to flow through to all users, just as it would allow much greater volumes of information to flow over the local loop. It would stimulate new investment and innovation in local telecommunications services that could be expected to have a significant positive impact on the American economy as whole, continuing and even accelerating the rapid improvement in American competitiveness experienced over the past decade.

We have already explained why neither a simple grant nor dismissal of the LCI Petition would provide a satisfactory resolution of the bottleneck issues identified by LCI. Moreover, since LCI proposed that adoption of its "Fast Track" proposal be strictly at the option of the BOCs, and it is likely that few if any BOCs would be willing to accept that offer, approval of the LCI Petition would probably be an empty gesture in any event. Rather than turn its back on these issues, the Commission should embrace this opportunity to investigate alternative approaches to the problem of the loop bottleneck. Since the comments on the LCI Petition are likely to be limited to the merits of LCI's particular approach, and interested parties should have an opportunity to comment on the broader issues discussed above, the Commission should immediately solicit a further round of comments discussing alternative policy approaches to the bottleneck issue.

In the following sections, we outline some potential approaches on which the Commission should seek comments. These suggestions are intended as possible areas for exploration, but may not encompass the Commission's full range of options. Other parties, including the BOCs, may have other suggestions that are worthy of consideration.

A. The "Independent System Operator" Concept

LCI's Petition mentions briefly, at pages 35-36 of its Petition, regulatory decisions to restructure the electric power industry as analogies to its proposal. In particular, it notes that California (among other jurisdictions) has required electric utilities to turn over control—but *not* ownership—of their bottleneck transmission facilities to an "independent system operator" or ISO. The ISO approach is actually much more consistent with the structural separation objectives set forth in Section II of these comments than is LCI's "Fast Track" proposal. Unlike "Fast Track," an ISO structure would remove the BOCs' control over the bottleneck loop facilities by establishing an independent entity to manage and operate these facilities. Because the BOCs would continue to retain ownership of the loop network, but would contract with the ISO to operate their facilities, there would be no issue of an "uncompensated taking" of property as long the ISO continued to charge regulated rates for use of the loop and paid the net proceeds of these rates (less its operating expenses) to the owner of the facilities.

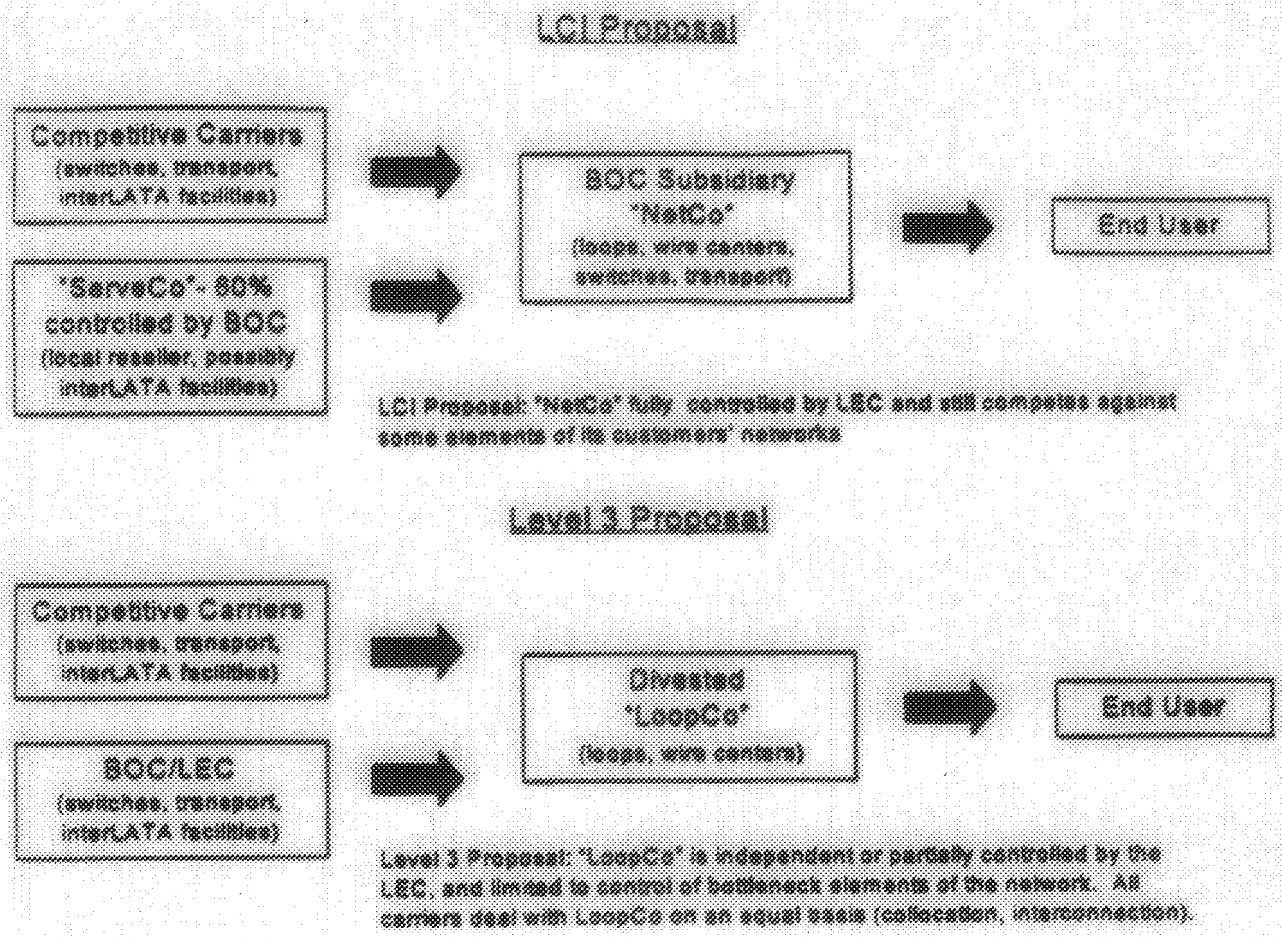
Under an ISO structure, the BOC would have to lease back loops from the ISO for use in providing retail (or wholesale) service to its customers, at the same price and in precisely the same manner (including the same access to operations support systems) as any other carrier. The BOC, like any other carrier, would have the option of constructing its own facilities to access customer premises instead of using the facilities controlled by the ISO; however, any such facilities would be built at the BOC's own risk and there would be no assurance of a regulated rate of return on this investment. These rules would assure that the ISO would have a strong economic incentive to charge cost-based, geographically-deaveraged rates for local loops in order to avoid construction of uneconomic facilities by other carriers.

Although an ISO certainly could be established on a voluntary basis, similar to the LCI proposal, the Commission should also consider whether it has legal authority under existing statutes to require BOCs or other incumbent LECs to participate in such a structure. Alternatively, the Commission should consider whether additional incentives besides interLATA relief (for example, price cap relief, pricing flexibility, forbearance, or other incentives) could be offered to LECs to encourage them to participate in an ISO. Along with the carrot, the Commission should also consider the stick of tightening regulatory restrictions on carriers that refuse to participate.

8. Full or Partial Divestiture of "LoopCo"

As another alternative, the Commission should consider requiring LECs to divest their bottleneck loop facilities, including central office buildings. The loops would be owned by a "LoopCo" (rather than the "NetCo" in LCI's proposal, which would control other facilities in addition to loops). Level 3's proposed "LoopCo" structure is compared to LCI's "NetCo" proposal in Figure 1, below. Other carriers, including the BOC, that wanted access to the loops would pay LoopCo for access to the central office (or other interconnection points) and connection to the loops, as well as (optionally) collocation of switches or other equipment in the buildings. Space rental rates which already exist in RBOC collocation tariffs and agreements can be used as a basis for establishing these relationships.

Figure 1



The LoopCo could either be a completely separate entity from the BOC (*i.e.*, complete divestiture through a spin-off of stock to the public), or a partially divested entity (similar to ServeCo in the LCI proposal). Empire City Subway Company, a subsidiary of Bell Atlantic which controls access to underground conduits in some boroughs of New York City, is an example of a separate subsidiary that has some of the characteristics of the proposed LoopCo. Empire City Subway provides access to its conduits both to Bell Atlantic and to other telecommunications carriers, ostensibly on a non-discriminatory basis, and subject to regulatory oversight. Of course, the greater the ownership interest (and potential control) that a BOC retained in LoopCo, the greater would be

the need for regulatory oversight of that relationship. One possible method of diluting the BOC's control over LoopCo would be to require a minimum number of outside public directors on the board of LoopCo, similar to the approach the Commission has taken with certain Comsat subsidiaries.

Conclusion

The LCI Petition raises an issue of the most central importance to telecommunications policy; namely, how to allow incumbent carriers to participate in competitive markets while at the same time preventing abuse of their control of bottleneck facilities. By filing this Petition and drawing attention to this issue, LCI has performed a major service to the Commission, to the entire industry, and to the public. Unfortunately, however, its proposed remedy for the problem falls short of accomplishing its stated aims.

Level 3 strongly supports LCI's goals of eliminating BOC conflicts of interest, promoting non-discriminatory and reasonably-priced access to bottleneck facilities, and (when these conditions are met) expediting BOC entry into long-distance service and removal of unnecessary regulatory restraints on these companies. To this end, Level 3 encourages the Commission to solicit further comments, on an expedited schedule, to allow it to consider other policy

options besides the LCI proposal and to permit it to develop an effective and lasting solution to the bottleneck problem.

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