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September 25, 1998

Ex Parte

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SEP 25 1998
FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
1919 M Street, N.W. - Room 222
Washington, D.C. 20554

Re: CC Docket No. 96-262

Dear Ms. Salas:

Yesterday, Mr. Bill Taylor of NERA, Mr. Ed Lowry, Mr. Ed Shakin, and I, representing Bell Atlantic, met with Bill Rogerson, Chief Economist for the FCC, Patrick DeGraba, CCB Chief Economist, and Jay Atkinson of the CCB's Competitive Pricing Division regarding the item captioned above. The attached material served as the basis for the discussion.

Any questions on this filing should be directed to me at either the address or the telephone number shown above.

Sincerely,

Ken. Rust

Attachment

cc: Mr. J. Atkinson
Mr. P. DeGraba
Mr. W. Rogerson

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List A B C D E

Prescriptive Regulation of Access Charges in Less-Competitive Areas

Just nine months after the Commission implemented the results from its multi-year review of access charges and price cap rules, the staff should not open the door to again consider additional prescriptive reductions. The Commission correctly rejected such an approach in its recent review. The same economic logic that fueled the rejection of such a policy then, should do so now. The fact that the current consideration would be more narrow – limited to areas considered less competitive – does not alter that view. Indeed, such a policy would actually have an anticompetitive impact for those areas.

- **More prescriptive regulation would undermine the incentives in price caps**. In its review of price cap regulation, the Commission recognized the beneficial impact of the incentives of price cap regulation. A prescriptive approach to access reform is a return to cost-based rate of return regulation and a repudiation of price cap regulation. If the Commission were to force rate reductions in excess of the newly imposed X factor, it would have disastrous effects on price cap regulation. Such actions would undermine regulatory credibility and disrupt long run market dynamics. In addition, any link, however tenuous, between the regulated firm's success in the market and the maximum price it is permitted to charge in the next period would re-establish the perverse incentives that price cap regulation was designed to avoid. As a result, the rational regulated business would have significantly smaller incentives to increase investment and improve efficiency.

- **Irrespective of competition, price cap regulation already ensures reductions in access rates.** The Commission rejected a prescriptive approach in part because it concluded that any reductions in rates should avoid large one-time changes and should instead be addressed over a period of years. The current price cap regulation already accomplishes this goal. As competitive services are removed from price caps, the regulated local exchange carrier will have fewer options as to how to spread the annual price cap reductions, and the downward pressure on the price of the services remaining in price caps will increase. Moreover, the low current and forecasted U.S. inflation rate implies that carrier access prices must fall in both nominal and real terms over time even for customers or geographic areas where competition is more limited.

- **In addition, the impact of competition is already being felt.** Facilities-based competition for special access and dedicated transport services is already highly developed in most markets. Competition for the business market has been quite successful: according to a recent analyst report from Salomon Smith Barney, in the first quarter of 1998, CLECs as a group added more business access lines than did the

RBOCs.[1] The Salomon Smith Barney report also estimates that, given the net lines added by CLECs in the first quarter of 1998, the annualized market share of the CLECs as a group is already 4 percent. With that share increasing 50-100 basis points per quarter, the CLECs are expected to have 7-8 percent market share at the end of 1998 and up to 10 percent by end-1999. This appears to agree with the Yankee Group prediction that over 11 per cent of local revenues will accrue to CLECs by 2000.

Competitive entry is facilitated by the many interconnection agreements, and by the provision of network elements and resold services at regulated rates. Barriers to entry into the local exchange market have fallen, and large business customers can be targeted by entrants having few sunk costs. The value of the new CLECs has also grown: evidence is the valuation placed on TCG by AT&T and on Brooks Fiber and MFS by MCI-WorldCom.

- **There is no economic need or logic in further reductions in access prices.**
    - **Under the assumption that the productivity factor was chosen correctly, implementing a lower price than the one brought about by price caps creates economic inefficiencies.** The X factor in a price cap plan should reflect the extent to which the regulated firm is capable of lowering its unit costs more rapidly than other firms in the economy. In that way, the price cap derived from the X-factor replicates the pricing discipline that competitive markets impose on competitors. Reducing prices artificially by regulatory prescription is the equivalent of choosing an X-factor that is too high. The economic harm that would follow would be that an efficient regulated firm would be unable to achieve the productivity growth needed so that its unit cost would fall to meet its new price. Though efficient, the firm would be forced to sell output at prices below cost. Holding other factors constant, this outcome would discourage investment by the regulated firm as well as entry by potential competitors.
    - **There is no economic basis to drive prices to incremental cost.** Total service long run incremental cost ("TSLRIC") is an appropriate price *floor*, (averaged over all the different prices charged for different units of a service) but it is not a good estimate of the market price of access in a competitive unregulated market. For a multiproduct firm with substantial fixed costs, incremental cost pricing is unsustainable in the long run and does not allow a firm to recover all of its economic costs of production. Experience from other industries—including the U.S. long distance industry—indicates that in the face of significant fixed costs, prices systematically exceed marginal cost. Allowing market forces to determine the mechanism to recover shared and

[1] "CLECs Surpass Bells in Net Business Line Additions for First Time (I/II)", Salomon Smith Barney (J.V. Grubman), May 6, 1998.

common costs results in more efficient pricing than one in which the Commission arbitrarily allocates such costs.

- **Even if it were appropriate to set prices to some measure of incremental costs, the Commission lacks a reliable method to accomplish the task.** Economic proxy models do not reflect the actual network and the manner in which it is used, and therefore would result in insufficient prices and a disincentive to invest. Moreover, current models are not developed for rural areas, leaving the Commission insufficient information to prescribe rates where competition is limited.

- **Regardless, as the Commission recognized, its access charge reform decision already set a framework to reduce the per-minute cost of access to a level approaching incremental cost.** By restructuring access rates so that per-line costs are no longer recovered on a per-minute basis, the Commission has increased the efficiency of access pricing structure and put in place a plan for automatic adjustments that together forestall the need for additional reductions in the per-minute rates.

- **Prescriptive price reductions will harm competition.** Reducing prices provide a disincentive for competitors to enter new markets. As prices are reduced, there is less potential return for a carrier that builds competing facilities. To the extent there is little competition, rate averaging in rural areas is one reason. Prescriptive access charge reductions would provide poor entry signals because such prices do not reflect their full economic costs. What is needed is deaveraged prices, not across-the-board non-economic reductions imposed by regulatory fiat.

- **Prescriptive price reductions will not benefit consumers**. Consumers only benefit if long distance carriers pass through the reductions. As the Commission has noted, there is substantial evidence to indicate that such price reductions, if passed through at all, are not being passed through completely or to most customers.