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

In the Matter of	)	
	)	
Access Charge Reform	)	CC Docket No. 96-262
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
MCI Telecommunications Corporation Emergency Petition for Prescription of Access Charges	)	CC Docket No. 97-250
	)	
Consumer Federation of America Petition for Rulemaking	)	RM-9210

COMMENTS OF GTE

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October 26, 1998

SUMMARY

Less than a year and a half after reductions in access prices totaling approximately $2.4 billion industry-wide following the agency's 1997 *Access Charge* and *Price Cap* decisions, the Commission is asking parties to "refresh" the record on access charge reform. Inexplicably, the Commission also is asking for comment on whether to adopt a prescriptive approach to access reform, notwithstanding the fact that it declined to adopt such far-reaching, prescriptive scheme in its *Access Reform Order*. Indeed, the Commission concluded in the *Order* that it planned to review these measures again after a review that was scheduled to begin on February 8, 2001. The Eighth Circuit affirmed the Commission's decision to reject a prescriptive approach.

GTE's position remains the same as it was a year and a half ago: Section 254 of the Act and sound public policy requires that all implicit subsidies be removed from access charges and replaced on a dollar-for-dollar basis with explicit universal service funding. The Commission must complete its current work on reforming the universal service support framework and replace the underlying implicit universal service support subsidies in access charges with explicit mechanisms. Only when this process is completed will access charges be at a level that will provide a reasonable starting point for a truly "market-based" approach.

The Commission failed to address the issue of implicit support at the time of its *Access Reform Order*. Instead, it permitted implicit universal service support to remain in access charges, reasoning that the market would reduce access to its economic costs over time. However, in this context, the term "market-based approach" is a misnomer because it eliminates implicit subsidies without providing a competitively

neutral mechanism to replace such subsidies. Rather, universal service support should be made explicit, sufficient, and predictable as required by law. Further, requiring ILECs to recover implicit support through their access charges, rather than through a competitively neutral mechanism, will not produce an efficient market outcome. Instead, it will invite cherry-picking, artificially promote entry into some access markets, and preempt entry into most markets for local service.

In any case, the Commission has no factual basis for any arbitrary reduction in access charges, either through a prescription of rates or through an increase in the productivity offset. The Commission's forward-looking cost model, while useful for some purposes, does not provide a reasonable basis for an arbitrary change in the overall level of ILEC prices. Neither does the recent productivity experience provide any justification for an increase in the X-factor. The current 6.5 percent X-factor is already too high. ILECs will not be able to achieve such a high level of productivity year after year.

Either approach to arbitrary rate reduction will undermine the very incentives that price caps have created and will increase regulation in the face of increasingly competitive access markets. Ultimately, such an approach will harm consumers because pricing will not have been reformed to more efficient levels in accordance with market principles, but will simply be reduced through arbitrary government mandate. Arbitrary access reductions will transfer revenues from ILECs to IXCs, without providing for the recovery of legitimate ILEC costs. Further, simply reducing the revenue that implicitly supports local service today will not provide correct price signals for carriers in local markets -- signals that should be provided by explicit universal

service support that is portable to new entrants.

GTE submits that the Commission should act immediately to implement a truly "market-based" approach by funding subsidies through explicit methods and adopting substantial pricing flexibility. Taking these steps now will contribute significantly to market-based and efficient pricing and will promote competition by laying the groundwork for correct economic signals for new entrants and incumbents alike. Therefore, the Commission should adopt the following proposal.

First, the Commission should adopt a Federal universal service plan sufficient to replace the universal service support generated today by interstate access. USTA has recently proposed a plan for nonrural ILECs that would address the implicit support provided by CCL and PICC rates. GTE supports this proposal, but notes that additional support flows generated by the current rates for switching and transport are not addressed by the USTA plan.

Second, the Commission should permit ILECs to price their access services flexibility. This framework should immediately allow ILECs, consistent with USTA's Phase I competitive trigger and subject to reasonable safeguards, to: (1) geographically deaverage prices of all access elements; (2) offer volume and term discounts; and (3) offer new access services with fewer impediments. The framework should also establish an orderly process for further streamlining of the Commission's access regulation, such as contract-based pricing and streamlines price cap baskets and bands, as reasonable competitive triggers are reached. USTA has developed a proposal which GTE supports, and which provides a sound basis for this regulatory framework.

Third, the Commission should eliminate the arbitrary distinction between primary and nonprimary residential lines because that distinction distorts competition by creating unreasonable distinctions in customer pricing and universal service support and is burdensome to administer.

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COMMENTS OF GTE

The Common Carrier Bureau ("Bureau") of the Federal Communications Commission ("FCC" or "Commission") issued a Public Notice inviting comments from interested persons to "refresh" the record on access reform.[1] In particular, the Bureau sought comment on the following broad issues: (1) prescription of access rates or reinitialization of price cap indexes ("PCIs"); (2) pricing flexibility for incumbent local exchange carriers ("ILECs"); and (3) the productivity factor, or "X-factor."[2] GTE Service

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[1] Public Notice, Commission Asks Parties To Update and Refresh Record For Access Charge Reform and Seeks Comment on Proposals For Access Charge Reform Pricing Flexibility, FCC 98-256 (rel. Oct. 5, 1998).

[2] *Id.* at 1-2.

Corporation and its below-listed affiliates[3] (collectively "GTE") submit these comments in response to the Bureau's public notice.

I. INTRODUCTION.

With industry-wide reductions in access prices totaling approximately $2.4 billion[4] following the agency's 1997 *Access Charge*[5] and *Price Cap*[6] decisions, the Commission – less than a year and a half later – is asking parties to "refresh" the record on access charge reform. Inexplicably, the Commission also is asking for comment on whether to adopt a prescriptive approach to access reform, notwithstanding the fact that it declined

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[3] GTE Alaska, Incorporated, GTE Arkansas Incorporated, GTE California Incorporated, GTE Florida Incorporated, GTE Hawaiian Telephone Company Incorporated, The Micronesian Telecommunications Corporation, GTE Midwest Incorporated, GTE North Incorporated, GTE Northwest Incorporated, GTE South Incorporated, GTE Southwest Incorporated, Contel of Minnesota, Inc., GTE West Coast Incorporated, and Contel of the South, Inc., GTE Airfone Incorporated, GTE Raillfone Incorporated, GTE Communications Corporation, GTE Wireless Incorporated, GTE Media Ventures Incorporated, and GTE Internetworking Incorporated.

[4] *See* Separate Statement of Commissioner Susan Ness, Federal-State Joint Board on Universal Service, CC Docket No. 96-45, FCC 98120 (June 22, 1998); *see* William E. Taylor, *Access Reform And Pricing Flexibility In Light Of Recent Developments In The Markets For Carrier Access Services*, Figure 1 (Attachment to USTA Comments, CC Docket Nos. 96-262, No. 94-1 and 97-250, RM-921 (filed Oct. 26, 1998)).

[5] *Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate and Structure and Pricing, End User Common Line Charges*, 12 FCC Rcd 15982 (1997) ("*Access Reform Order* "), *aff'd sub nom. Southwestern Bell Tel. Co. v. FCC*, 153 F.3d 523 (8th Cir. 1998) (*"Southwestern Bell"*), Order on Reconsideration, 12 FCC Rcd 10119 (1997), Second Order on Reconsideration and Mem. Opinion and Order, 12 FCC Rcd 16606 (1997).

[6] *Price Cap Performance Review for Local Exchange Carriers, Access Charge Reform*, 12 FCC Rcd 16642 (1997) (Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262) ("*Price Cap Order*").

to adopt such far-reaching, prescriptive scheme in its *Access Reform Order*.[7] Indeed, the Commission concluded in the *Access Reform Order* that it planned to review these measures after a review that was scheduled to begin on February 8, 2001.[8] The Eighth Circuit affirmed the Commission's decision to reject a prescriptive approach.[9]

GTE's position remains the same as it was a year and a half ago: Section 254 of the Act and sound public policy requires that all implicit subsidies be removed from access charges and replaced on a dollar-for-dollar basis with explicit universal service funding. The Commission must complete its current work on reforming the universal service support framework and replace the underlying implicit universal service support subsidies in access charges with explicit mechanisms. Only when this process is completed will access charges be at a level that will provide a reasonable starting point for a truly "market-based" approach.

The Commission failed to address the issue of implicit support at the time of its *Access Reform Order*. Instead, the Commission permitted implicit universal service support to remain in access charges, reasoning that the market would reduce access to its economic costs over time.[10] However, in this context, the term "market-based approach" is a misnomer because while a regime that permits competition to discipline access prices is proper, one that also eliminates implicit subsidies without providing a

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7 *Access Reform Order* at ¶¶ 258-98.

8 *Access Reform Order* at ¶¶ 267-269.

9 *Southwestern Bell Tel. Co. v. FCC*, 153 F.3d 523 (8th Cir. 1998).

10 *Access Reform Order* at ¶¶ 7-11, 32.

commensurate competitively-neutral funding mechanism for such subsidies is not. In other words, universal service support should not be eroded by competitive forces, but instead must be made explicit, sufficient, and predictable. Further, requiring ILECs to recover implicit support through their access charges, rather than through a competitively-neutral mechanism, will not produce an efficient market outcome. Instead it will invite cherry-picking, artificially promote entry into some access markets, and preempt entry into most markets for local service.

In any case, the Commission has no factual basis for any arbitrary reduction in access charges, either through a prescription of rates or through an increase in the productivity offset. The Commission's forward-looking cost model, while useful for some purposes, does not provide a reasonable basis for an arbitrary change in the overall level of ILEC prices. Neither does the recent productivity experience provide any justification for an increase in the X-factor. The current 6.5 percent X-factor is already too high. ILECs will not be able to achieve such a high level of productivity year after year.

Either approach to arbitrary rate reductions will undermine the very incentives that price caps have created and will increase regulation in the face of increasingly competitive access markets. Ultimately, such an approach will harm consumers because pricing will not have been reformed to more efficient levels in accordance with market principles, but will simply be reduced through arbitrary government mandate. Arbitrary access reductions will transfer revenues from ILECs to IXCs, without providing for the recovery of legitimate ILEC costs. Further, simply reducing the revenue that implicitly supports local service today will not provide correct price signals

for carriers in local markets – signals that should be provided by explicit, portable universal service support that would be portable to a new entrant.

GTE submits that the Commission should act immediately to implement a truly "market-based" approach by funding subsidies through explicit methods and adopting substantial pricing flexibility. Taking these steps now will contribute significantly to market-based and efficient pricing and will promote competition by laying the groundwork for correct economic signals for new entrants and incumbents alike. Therefore, the Commission should:

- Adopt a Federal universal service plan sufficient to replace the universal service support generated today by interstate access. USTA has recently proposed a plan for nonrural ILECs that would address the implicit support provided by CCL and PICC rates. GTE supports this proposal, but notes that additional support flows generated by the current rates for switching and transport are not addressed by the USTA plan.

- Allow ILECs to price their access services flexibility. This framework should immediately allow ILECs, consistent with USTA's Phase I trigger and subject to reasonable safeguards, to (1) geographically deaverage prices of all access elements; (2) offer volume and term discounts; and (3) offer new access services with fewer impediments. The framework should also establish an orderly process for further streamlining of the Commission's access regulation as reasonable competitive triggers are reached. USTA has developed a proposal which GTE supports, and which provides a sound basis for this regulatory framework.[11]

- Eliminate the arbitrary distinction between primary and nonprimary residential lines because that distinction distorts competition by creating unreasonable distinctions in customer pricing and universal service support and is burdensome to administer.

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[11] Even assuming, however, that the Commission may reject these proposals, it should not exacerbate the problem by adopting the IXCs' proposed price cap changes.

II. BACKGROUND.

On December 24, 1996, after years of promises to begin comprehensive access reform, the Commission released a Notice of Proposed Rulemaking seeking comment on reform of access charges for price-cap LECs.[12] This proceeding was one part of the Commission's trilogy (the other two were interconnection and universal service) that were to form the bedrock for implementation of the 1996 Act. On May 8, 1997, the Commission adopted the *Access Reform Order*, stating that it would use a so-called market-based approach to regulating access charges and indicating that a more regulatory approach, such as prescribing access rates or reinitializing price cap indexes, would be considered after a review that was scheduled to begin on February 8, 2001.[13]

Notwithstanding this conclusion, the Commission adopted only a small portion of access reform, to be implemented over a three-year period that is not yet complete. Most importantly, the Commission failed to remove all implicit subsidies from access charges. Additionally, in a companion order, the Commission increased the X-factor to 6.5 percent and applied this new X-factor retroactively to PCIs "as if" it had been adopted for the 1996 access year.[14] While these decisions led to a decline in access

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12 *Access Charge Reform Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing*, 11 FCC Rcd 21354 (1996) ("*Access Charge NPRM*").

13 *Access Reform Order* at ¶¶ 267-269.

14 *Price Cap Order* at ¶¶ 177-181.

prices of approximately $2.4 billion industry-wide, they did nothing to address the substantial implicit subsidies that remain in access charges.[15]

III. THE COMMISSION SHOULD REPLACE THE IMPLICIT UNIVERSAL SERVICE SUPPORT GENERATED TODAY BY INTERSTATE ACCESS WITH EXPLICIT, COMPETITIVELY-NEUTRAL FUNDING.

The Commission must proceed now to give effect to its original conclusion to establish a truly market-based access pricing system. The first step in this process is to replace the support for universal service that is now generated implicitly by interstate access. The Commission has so far failed to complete this task, but has the opportunity to do so now.

GTE estimates that for the non-rural ILECs the amount of implicit subsidy that remains in interstate access charges is $6.3 billion.[16] USTA has recently proposed a universal service plan for nonrural ILECs that would replace the amount of implicit support generated today by interstate CCL and PICC charges, which is currently about

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[15] In its Orders, the Commission adopted a new rate element, the PICC charge. The efforts of IXCs to pass this charge through to end users have given rise to considerable confusion and controversy. In addition, the Commission promised to address pricing flexibility reforms in a separate order in the near future, though a decision has not yet been issued.

[16] To calculate this estimate, GTE constructed an average nationwide rate per switched access minute (per end) that reflected an estimate of the forward-looking cost of switched access, but that was also consistent with GTE's current revenue level. This rate is about $.008 per minute. This represents the rate GTE might charge if its rates for all services were rebalanced to reflect the relative forward-looking costs of each service, while recovering the same overall cost level as GTE's current rates. The difference between access revenues at current interstate access rates and what access revenues would be at this rebalanced rate is about $6.3 billion annually.

$4.3 billion.[17] USTA proposes that this flow of implicit funding should be replaced by explicit, portable support amounts which would be made available to carriers who provide universal service within each study area. Access charges would be reduced accordingly: the CCL and PICC charges would be eliminated. The funding for this plan would be raised through a competitively neutral surcharge on the retail revenues – both state and interstate – of all telecommunications service providers.

GTE supports the USTA proposal. If adopted, it would make possible a major step in eliminating implicit support from access, thereby allowing access rates to move much closer to their efficient market levels. Analysis of a large sample of individual end-user bills indicates that residence customers at all income levels would be made better off by the adoption of the USTA proposal.[18]

In contrast to the USTA proposal, a "market–based" approach which ignores the support flows now implicit in access charges, and which seeks to eliminate them through market forces, cannot be sustained as either a policy or legal matter. These subsidy amounts represent real costs that cannot simply be assumed away. ILECs will not be able to compete effectively until these subsidies are replaced with a competitively-neutral mechanism for the recovery of the underlying costs. Further,

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[17] Letter from John Hunter to Magalie Roman Salas, CC Docket 96-45 (Sept. 24, 1998). The USTA plan would include any recovery components, including the non-service specific TIC costs. USTA also recognizes the need for the federal universal service fund to provide support to states with relatively high cost, to help replace implicit support currently generated by state rates for services such as access, toll, vertical features, and local business service.

[18] However, because it focuses narrowly on the support generated by common line rates, the USTA plan does not address about $2 billion in implicit support which is provided today by traffic sensitive interstate access rates for switching and transport.

CLECs will not be able to compete effectively for local service, especially service to residential customers, until they are afforded access to the implicit subsidies that support those customers today. Because implicit support can never be made portable, the revenue sources necessary to make local competition possible can only be made available to CLECs when support is made explicit.

From the outset, the use of access charges to support affordable local service creates severe distortions in market incentives, inhibits the development of competition, and prevents firms from making efficient entry and investment decisions. Carriers are given an artificial incentive to provide access services to high-volume end users. At the same time, entry into local markets is largely preempted, because the revenue that supports the majority of residence local subscribers does not come from the rates those customers pay, but instead is generated by customers who purchase large volumes of access, and other state-regulated services that provide implicit support. These low-volume customers will never be an attractive business proposition for CLECs until the funds that support them are made available to any serving carrier through explicit, portable support.

Arbitrary reductions in access prices, without corresponding universal service funding, cannot correct these market distortions; they would simply create a situation in which *no* carrier had access to the funding that residence local customers need. Replacing the current implicit support with universal service funding, in contrast, will correct prices in both markets. It will provide a starting point for a truly "market based" approach toward interstate access and will make possible the kind of local competition Congress intended when it passed the 1996 Act.

IV. THE COMMISSION SHOULD NOT ATTEMPT TO REDUCE ACCESS CHARGES IN THE ARBITRARY MANNER ADVOCATED BY THE IXCs.

A. Once Universal Service Support Has Been Made Explicit, The Commission Will Be In A Position To Pursue A True "Market-Based" Approach.

Once the Commission has taken effective action to replace the implicit support in today's access rates, it will be in a position to adopt a true "market-based" approach. In the *Access Reform Order*, the Commission properly concluded that an approach that "relies on competition itself" to adjust interstate access charges "will, in most cases, better serve the public interest" than a prescriptive approach.[19] As the Commission recognized, "competitive markets are far better than regulatory agencies at allocating resources and services efficiently for the maximum benefit of consumers."[20] As the Commission further stated, a "market-based approach to rate-regulation should produce . . . a better combination of prices, choices and innovation than can be achieved through rate prescription."[21] This decision was affirmed by the Eighth Circuit in *Southwestern Bell Telephone Company v. FCC*.[22]

Nothing has changed since May 1997 that would suddenly justify adoption of a prescriptive approach now. Neither the record in this proceeding nor sound economic

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19 *Access Reform Order* at ¶ 44.

20 *Access Reform Order* at ¶ 42.

21 *Id.* at ¶ 289.

22 *Southwestern Bell*, 153 F.3d at 546-548. GTE, however, continues to believe that the Commission was incorrect in not immediately requiring the removal of implicit subsidies from access charges. *See id.* at 536-39.

theory offers any basis to alter the Commission's conclusion that prescribing access charge rates is "at best an imperfect substitute for market forces" and cannot "replicate the complex and dynamic ways in which competition will affect the prices, service offerings and investment decisions" of all parties.[23] Indeed, the Commission has so far failed to make the concomitant modifications of regulation that would make a "market-based" approach to access meaningful. As discussed above, the Commission has yet to establish a universal service fund to replace the implicit support including access. Further, while the Commission recognized in its *Access Order* that pricing flexibility would be necessary if market forces were to guide access prices, the Commission has yet to take any action to provide reasonable access pricing flexibility to ILECs. The Commission should move forward promptly to address these urgent issues, rather than adopt the arbitrary, prescriptive approach to setting access charge rates urged by MCI, CFA, and others.

Even if the matters of universal service and pricing flexibility are properly addressed, it is still reasonable to expect that subsequent market-driven adjustments in access prices may take some time. As the Commission itself noted, "a market-based approach . . . may take several years. . . ."[24] The Commission also recognized the need for a sufficient transition period to allow competitive forces to drive access pricing

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[23] *Access Reform Order* at ¶ 289.

[24] *Id.* at ¶¶ 45, 262-284. The Commission affirmed this position as recently as December 1997 in its Brief filed in the U.S. Court of Appeals for the Eighth Circuit in support of the *Access Reform Order*. *See* Brief of Respondents, Federal Communications Commission, *Southwestern Bell Telephone Co. v. FCC*, No. 97-2618 *et al.* (8th Cir. filed, Dec. 16, 1997).

toward economic cost by setting a February 8, 2001 date for price cap LECs to complete cost studies for interstate access services.[25] Accordingly, the Commission should reject as premature any suggestions to turn to an arbitrary and prescriptive approach only one and one-half years after *the Access Reform Order* was adopted.

B. The Current Level Of Access Prices Represents A Policy-Driven Distortion In Relative Rates, Not A Distortion In Overall ILEC Cost And Revenues.

It is widely recognized that interstate access charges have been set at a level which exceeds the level a competitive market would set, given the underlying cost of providing access and the demand for the service. The dichotomy between current rates and those that a competitive market would set reflects historical policy choices made by regulators.[26]

Because access rates have been set in accordance with regulatory fiat rather that market forces, they are vulnerable to opportunistic arguments, such as those raised by MCI and CFA. These parties suggest that access rates should similarly be reduced by fiat, either through the adoption of a results-oriented choice X-factor, or more simply through a prescriptive reduction. Unfortunately, such arguments ignore the fact that access charges are currently above cost for good reason, namely, to generate implicit support for universal service. As GTE has discussed above, the first step in reform is to correct this relative price distortion. Specifically, access charges

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25 *Access Reform Order* at ¶¶ 267-268.

26 GTE has recognized this fact in developing its estimate of the implicit support in access, which is based on a comparison with an estimated market rate.

should be reduced to eliminate the universal service contribution, this amount should be raised by a competitively-neutral surcharge, and the explicit support should be available to local carriers who provide universal service.

Because access charges are at current levels for good reason, it does not (and cannot) follow that ILEC costs in general are simply "too high," or that ILEC rates may (or should) be reduced arbitrarily in the absence of explicit universal service funding. In fact, precisely the opposite is true: only when the rebalancing made possible by explicit universal service funding has been completed can a "market-based" approach address whether ILEC costs are at a proper level or not.

Today, because of the *relative* distortion in ILEC rates, it is impossible to determine whether ILECs are efficient or inefficient overall, relative to other providers. If a carrier enters the market for access to high-volume customers, it may be because the new carrier is efficient, or it may be in response to the relatively high current prices for access. If no carrier enters the market for local service, this may indicate that ILECs are very efficient local service providers, or it may mean that local rates are too low to recover any carrier's costs of local service. The Commission's first objective must be to correct this relative price distortion, which it can do by implementing sufficient and explicit universal service funding. Only when this has been accomplished can carrier entry decisions in each market – access and local – reveal meaningful information about ILEC costs. GTE therefore believes that the Commission must focus its efforts on this task, rather than speculating about what an efficient level of overall ILEC cost might be. Simply stated, it is erroneous to assume that ILEC costs are not already at efficient levels overall.

C. There Is No Basis For Adopting A Higher X-Factor.

Since the Commission first adopted its price cap plan for ILECs, the level of interstate access charges has fallen by about 50%.[27] The price cap plan has thus been successful in prompting ILECs to improve efficiency, and significant benefits have resulted in the form of lower rates. In its most recent review of ILEC productivity, the Commission interpreted the record before it in a highly selective manner and made speculative assumptions about future productivity, in order to arrive at an X-factor of 6.5%. The experience of the last eighteen months has not borne out the Commission's predictions, and therefore cannot not provide any basis for a further increase in the X-factor. In fact, the data from this period is unequivocal in that the Commission set the X-factor too high.

USTA has completed estimates using the Commission's own productivity model and data from 1996 and 1997. Even if the Commission's model is taken as given, the estimated X-factor for those years would be 2.1% and 4.1% respectively. While GTE does not agree that the Commission's model is a reasonable approach for estimating the X-factor, these results indicate that productivity is not trending upward, as the Commission assumed in order to justify its "stretch" to 6.5% in the *Price Cap Order*. If anything, the data indicate that productivity improvements are declining. In any event, experience, as opposed to assumptions, provides no basis for adopting an increase in the X-factor.

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[27] *See* William E. Taylor, *Access Reform and Pricing Flexibility In Light of Recent Developments in the Market for Carrier Access Services*, Figure 1 (Attachment to USTA Comments, CC Docket No. 96-262, 94-1, 97-250 RM-9210 (filed Oct. 26, 1998)).

D. The Cost Models Do Not Provide A Basis For Prescribing Rates.

The Commission is now in the process of developing a model to provide estimates of forward-looking cost. The Commission recently adopted the "platform" for this model. Some parties have suggested that access rates should be arbitrarily reduced to the level of the forward-looking cost estimates for access services generated by this model. In fact, while the model will prove to be useful to the Commission in a number of important ways, the model does not provide a basis for prescribing interstate access rates.

While the recent efforts of the Commission staff have brought about improvements to the model "platform," it is not reasonable to expect that the model, when completed and populated with input data, will provide estimates of forward-looking cost that can be relied on to prescribe rates, in the absence of any other information about the ILECs' costs and revenues. Largely because it is static in nature, the model will not estimate the correct cost concept of forward-looking economic cost; it will ignore important components of that cost. In order to estimate costs for many small geographic areas across the country, the model must operate on a drastically simplified view of reality. Finally, securing input data for models of this kind has proven to be difficult, imprecise, and shrouded in controversy. As a result of these inherent difficulties, the models developed to date have produced results which differed wildly when compared with one another or with any reasonable comparison to reality. Although the staff may, through their development efforts, improve on both the model platform and inputs compared to these earlier efforts by model sponsors, it is not

reasonable to expect that they will be able to alter the fundamental limitations of this approach to cost estimation.

Further, even if the model were to estimate forward-looking cost perfectly, they would still not provide a basis for the prescription of rates. Casual observation of real-world markets reveals that TSLRIC costs are not good predictors of market prices. Consider, for example, the market for long-distance telephone service. Estimates of the TSLRIC cost of long distance service generally fall between 1 and 2 cents per minute.[28] In a recent study of long distance pricing, Paul Brandon and William Taylor calculated the margin generated by IXC rates, based on the difference between IXC rates to end users and the access charges IXCs paid for those customers' access minutes. For AT&T, during the period after January 1, 1998, the average margin for residence customers was 12 cents per minute, or roughly eight times AT&T's TSLRIC cost of providing the service.[29] In subsequent rate actions after July 1, 1998, AT&T increased its average margin by $.0197. This *increase* alone is larger than the TSLRIC of long-distance service.[30] Clearly, one cannot estimate rates for long distance service – even

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[28] In a recent Commission forum on access reform and universal service, AT&T representative Joel Lubin gave an estimate of 1.5 cents per minute as the TSLRIC of interstate long distance, which falls in the middle of the range.

[29] *See* Brandon, Paul, and William Taylor, *AT&T, MCI, and Sprint Failed to Pass Through The 1998 Interstate Access Charge Reductions To Consumers*, (filed under letter from Roy Neel of USTA to Chairman Kennard, dated October 21, 1998). Margins cited are displayed in Table 3, page 14.

[30] *Id.* at Table 4, page 19.

in a market where the Commission has found that no firm has market power – simply by estimating TSLRIC costs.

Further, while the models may provide useful information concerning the relative forward-looking costs of different services, or of different geographic areas, these models have not generally been reliable as measures of the overall level of costs experienced by a multi-product telecommunications firm. One method for assessing the overall cost level predicted by a model is to calculate the revenue the firm would have if it sold its entire output at the unit prices estimated by the model. For example, if GTE were to sell the entire output of services produced in its serving area in Texas at the UNE rates produced by the HAI model (using its default inputs), its revenue would be about 57% less than it is today.[31] GTE is concerned that the Commission may use its model to derive estimates of individual prices in different markets – such as the price of local service, in the context of universal service, or the price of switched access, in the context of access reform – without ever asking itself whether the overall cost level implied by these estimates is reasonable.

As noted above, the mere fact that access prices are higher than the level a forward-looking model would indicate is not, by itself, evidence that ILECs are operating inefficiently, since it is well known that access has traditionally carried a high margin in order to support local service. Even if the TSLRIC cost itself could be estimated accurately (which it cannot), the margin required to cover common costs, and the

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[31] Of course, if the comparison is based on UNE rates, one would expect a difference in revenue reflecting the cost of retailing. In Texas, the "avoided cost" discount for retailing expense is 23%.

manner in which those common costs would be recovered through rates for the different services the firm offers, is not revealed by the model. While in the case of network costs the models at least give the appearance of simulating some actual network, in the case of common costs there is nothing for the model to simulate; as a result, in all of the existing models the estimates of common costs are really nothing more than guesswork.

E. A Prescriptive Approach Using Forward-Looking Costs Would Result In An Unconstitutional Taking, And Would Also Run Afoul Of Section 201(B).

For the last eight years, the Commission has used price cap regulation to ensure that ILEC access rates were just and reasonable. At the start of the price cap plan, rates were initialized at levels which had resulted from the Commission's previous rate-of-return regulation. The Commission has found that price cap mechanism is a reasonable method of regulation that captures changes in ILEC costs over the same time period, and provided an incentive for ILECs to improve efficiency, while at the same time (if the parameters of the price cap formula were set reasonably) they allowed ILECs a reasonable opportunity to recover their costs.[32]

Prescription of access rates based on estimates of forward-looking cost would represent an arbitrary change from this well-proven method of regulation. Such an arbitrary action, absent an adequate mechanism for cost recovery, would represent an unconstitutional taking of ILEC property. In addition to this constitutional concern,

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[32] *Access Charge Reform Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing*, 11 FCC Rcd 21354, 21369-71 (1996)

preventing ILECs from recovering the costs incurred supplying interstate access is also contrary to the Communications Act's mandate that rates be "just and reasonable,"[33] a provision unaltered by the 1996 Act.

F. Prescribing Rates Would Be Anticompetitive And Undermine The Incentives In Price Caps.

As GTE and others have explained, a prescriptive approach to access reform is antithetical to competition and will fail to meet the stated goal of efficient pricing.

Under price cap regulation, ILECs can use pricing flexibility to earn a return, as long as the prices for various baskets of services stay below the relevant ceiling. It is this profit motive, which the Commission previously has found, that makes price cap regulation an appropriate simulator of competition by encouraging efficient behavior.[34] This conclusion is just as true today as it was when price cap regulation was adopted. Effectively eliminating price caps through a prescription would thus harm the competitive behavior the FCC was trying to promote.

Initial price cap indexes were set based on rates that were established under rate base regulation.[35] Since that time, the indexes have been increased annually by an inflation factor, decreased by an industry-wide efficiency factor, and adjusted for exogenous costs. Therefore, ILECs each year have had to find ways to become more

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("*Access Charge NPRM*").

33 47 U.S.C. § 201(b) (1998).

34 *Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, 5 FCC Rcd 6786, 6787 (1990) ("*Price Cap Second Report and Order*").

35 *Id.* at 6789.

efficient. However, each year's profits are built on the efficiency measures taken in the previous year, dating back to the origination of price cap regulation. By reinitializing the PCIs yet again, together with the continued threat that PCIs might be reinitialized in the future, the agency would undermine ILEC incentives to achieve greater efficiencies, destroy legitimate business expectations, and envenerate current and future shareholder confidence in ILEC businesses.

V. THE COMMISSION MUST ACT NOW TO INSTITUTE SUBSTANTIAL PRICING FLEXIBILITY FOR ACCESS CHARGES IN ORDER TO PROMOTE COST-BASED PRICING AND TO ENCOURAGE COMPETITION.

In its *Access Reform Order*, the Commission recognized that pricing flexibility for access was necessary in order for the "market-based" approach to perform as intended.[36] Unfortunately, since the release of the *Order* no further action on pricing flexibility has been taken by the Commission. Based upon the "refreshed" record in this proceeding, the Commission should now begin to rely on market forces and accelerate its initiative by addressing pricing flexibility as expeditiously as possible in order to permit a competitive market environment to flourish. Specifically, the Commission should adopt a framework which allows ILECs to adjust their access prices, with reasonable safeguards, to more accurately reflect differences in cost and to respond to competition from alternative providers of access.

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36 *Access Reform Order* at ¶ 49.

A. GTE Supports USTA's Proposal For Pricing Flexibility.

In its comments in this proceeding, USTA will propose a framework for reform of the Commission's rules governing the pricing of access.[37] GTE supports USTA's proposal, which is consistent with the goal of promoting competition established in the 1996 Act. USTA proposes a three phase approach to pricing flexibility.[38] In Phase I, after a state-approved interconnection agreement or statement of generally available terms, an ILEC will be permitted to introduce new services without first making a public interest showing. Further, the Commission would eliminate the Part 69 rate elements in order to remove barriers to the introduction of new services and permit flexible rate structures that promote economic cost recovery.[39] ILECs would be allowed to establish, within reasonable limits, geographically deaveraged rates which would reflect differences in cost, and would also be able to offer volume and term discounts for switched access. In Phases II, and III, additional streamlining would take place as competitive triggers are met in each market area; in Phase III, services would be removed from price cap regulation.

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[37] *See generally* Comments of United States Telephone Association, CC Docket No. 96-262, 94-1, 97-250, RM 9210 at 22-29 (filed Oct. 26, 1998) ("USTA Comments").

[38] *See generally id.*

[39] *See generally id.*

B. Competitive Triggers Should Not Be Established In Such A Way As To Delay Cost-Based And Competitively Beneficial Pricing.

1. Many aspects of the pricing flexibility proposals are designed simply to achieve cost-based pricing that the Commission has traditionally found beneficial even without proof of competition.

A number of the pricing flexibility proposals are designed to allow access prices to more accurately reflect underlying differences in cost. There is thus no need for the Commission to wait for a greater degree of competition in order to implement them. In fact, the Commission historically has relied on cost-based prices and never required a competitive justification for those rates.[40] Cost-based pricing is good for customers even in non-competitive environments. In addition, at base, cost-based prices are pro-competitive by sending the appropriate signals to prospective competitors and avoid both inefficient entry and uneconomic deterrence of efficient entry.

2. Failure to grant pricing flexibility has slowed facilities-based competition because irrational access pricing sends distorted pricing signals to the market.

Failure to adopt reasonable pricing flexibility is depriving consumers of the benefits of efficient pricing. This failure also is sending false signals to the market as to the true cost of providing access, which in turn, distorts competition and leads to perverse market behavior. Once implicit subsidies are eliminated and substantial

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[40] See generally TELPAK Proceeding, 61 FCC2d 587, ¶¶ 66-67 (1976), *recon. granted in part and den. in part*, 64 FCC2d 971 (1977), *recon.* 67 FCC2d 1441 (1978). By recounting the FCC's traditional cost-based pricing determinations, GTE is not endorsing more recent action to adopt TSLRIC-based pricing based on hypothetical cost modes.

pricing flexibility is adopted, consumers will begin to benefit from cost-based, efficient pricing. To facilitate full competition as envisioned by Congress, the Commission must allow ILECs to price rationally in accordance with market principles and must eliminate all unnecessary and destructive barriers to competition. As the Commission has itself acknowledged:

> [I]naccurate pricing signals encourage uneconomic bypass of incumbent LEC facilities and could very well skew or limit the development of competition in the markets for telecommunications services. Furthermore, these rates may not be sustainable in the long run if unbundled network elements are made available at cost-based prices and used to provide exchange access services.[41]

The Commission's current rules impose unnecessary constraints on access prices which cause inaccurate price signals to be provided to access customers. Most access elements must be averaged across study areas, even though the costs of access vary within those areas. The Part 69 rate structure, and the requirement for a public interest showing, create unnecessary barriers to the introduction of new access services. And switched access is perhaps the only major telecommunications service in the world whose prices are not permitted to incorporate nonlinear volume and term discounts, which reflect the underlying cost characteristics of the service and encourage access customers to make efficient choices.

Rather than impose unnecessary constraints on access pricing, the Commission's access rules should focus more narrowly on those few safeguards which may be necessary to ensure against unreasonable or anticompetitive pricing of access. For this reason, the USTA proposal incorporates important improvements in flexibility in

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41 *Access Charge NPRM* at ¶ 55.

Phase I, before any triggers associated with "addressability" of access markets by competitors have been satisfied. With reasonable safeguards in place, these reforms will allow access prices to become more efficient, and will allow new services to be introduced more readily, without compromising the protections for consumers that access regulation is intended to provide.

C. Geographic Deaveraging Will Bring Access Pricing More In Line With Costs, Which Will More Properly Set The Stage For Competition Based On Economic Motivations Rather Than False Price Signals.

To ensure that appropriate pricing signals are sent to CLECs and that facilities-based competition is not preempted, the Commission should allow ILECs to geographically deaverage rates for access elements. As stated previously, the flexibility to deaverage should not be contingent upon any competitive triggers beyond the basic requirement of USTA's Phase 1.[42] Such a restraint would ignore the role deaveraging plays in efficient pricing regardless of the state of competition and would harm consumers by delaying competition. Reasonable safeguards can be put in place which would protect consumers in high cost areas.

ILECs should be allowed to deaverage the SLC using the same small geographic areas used for universal service high cost support purposes. Such deaveraging is essential to recognize wide variations in the cost of local loops and avoid implicit cross-subsidies between high cost and low cost areas and consistent with 47 U.S.C. § 254(e). If such deaveraging results in SLCs in high cost areas that raise

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[42] GTE Access Charge NPRM Comments at 50.

concerns over the affordability of service, then this is a universal service issue. If it is found to be necessary to limit increases in SLCs in high cost areas to promote affordability, then this cap should be made possible by explicit universal service funding, not by averaging with lower cost areas. Deaveraging is critically important to creating rationally priced access charge elements, including the SLC. While ILEC costs vary in different geographic areas, the Commission's rules require averaged rates across large territories. Both the cost and price of local service can vary widely from one serving area to another.[43] To the extent that the SLC is averaged across all local markets, it will be too low in some areas, and too high in others. Indeed, the Commission has recognized the competitive distortion created by geographic averaging:

> [D]iscrepancies between price and cost distort competition by creating incentives for entry in low-cost areas by carriers whose cost of providing service is actually higher than the incumbent LEC's cost of serving that area. Similarly, geographic averaging across large geographic areas distorts the operation of markets in high-cost areas when we require incumbent LECs to continue offering services in those areas at prices substantially lower than their costs of providing those services. Prices that are below cost reduce the incentives for entry by firms that could provide the services as efficiently, or more efficiently, than the incumbent LEC.[44]

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[43] *Amendment of Part 36 of the Commission's Rules and Establishment of a Joint Board*, 9 FCC Rcd 7404 (1994). The most obvious piece of information about costs produced by the forward-looking cost models is that costs vary widely from one small area to another.

[44] *Access Charge NPRM* at ¶ 183.

Deaveraging will allow ILECs to price efficiently and to compete for switched access services in a manner that is consistent with costs and competitive alternatives,[45] and will eliminate the historical subsidy to rural rates that is currently found in urban rates. This result is consistent with the Telecommunications Act of 1996. When it established zones for certain switched transport elements, the Commission acknowledged the need to accommodate differences in cost attributable to traffic density.

Zone-based pricing addresses these differences. However, the Commission has not permitted any other access elements to reflect geographic differences in cost. The Commission should act to remedy this deficiency in its rules. GTE has had before the Commission for three years a Petition to provide reasonable geographic deaveraging of its switched access rates.[46] The Commission should adopt a framework for its switched access rules which would permit this reasonable deaveraging without the need for a waiver.

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[45] Deaveraging access service rates will promote competition rather than creating additional distortions. In contrast, deaveraging unbundled loops should not precede deaveraging local rates because doing so would invite uneconomic arbitrage and impede fair competition. GTE has made a specific proposal to address mismatching between averaged UNE rates and de-averaged universal service support. Comments of GTE, CC Docket Nos. 96-45, 97-160 and DA 98-715 (filed May 15, 1998) (Exhibit 1).

[46] Petition For Waiver of the GTE Telephone Operating Companies (filed November 27, 1995) (GTE is seeking a waiver to provide ZonePlus initially in five study areas: California, Texas, Oregon, Washington, and Florida).

D. Volume And Term Discounts Reflect The Underlying Structure Of Costs And Will Not Hinder Competition.

The Commission should allow ILECs to offer volume and term discounts immediately, as part of Phase I in the USTA proposal. These discounts are justified based on cost savings and will in no way hinder competition. As the Commission has recognized that "significant benefits . . . may result from volume and term discounts, including the possibility that volume and term discounts may enable an incumbent LEC to reflect its actual costs more accurately."[47] Volume discounts recognize the economies of scale in providing switched access services, which means that the additional cost of incremental access minutes is less than the average cost. Term discounts recognize the cost savings achieved from reducing customer churn and transaction costs from a stable service environment. The Commission's concern that CLECs might somehow be disadvantaged by allowing ILECs to offer these discounts is unjustified.[48] Currently, CLECs already can provide such discounts without any restraints or preconditions. ILECs will only be able to compete effectively in the new marketplace if allowed to price with the same flexibility as CLECs. Virtually every other telecommunications service in the world – except switched access – is offered at rates which include volume and term discounts. This is true in regulated monopoly markets, just as it is in highly competitive, unregulated markets. In the case of interstate long distance services, the Commission allowed AT&T to begin offering optional plans

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[47] *Access Charge NPRM* at ¶ 190.

[48] *Id.*

incorporating volume and term discounts in 1984 – long before it found that AT&T had lost market power.

Some parties have suggested that the use of volume discounts by ILECs could handicap smaller IXCs in competition with larger ones. GTE has proposed an innovative volume discount plan in which the discounts are based on the volume of the end-user, not on the size of the IXC. This allows the ILEC to establish efficient nonlinear prices for switched access, while at the same time ensuring that any IXC, regardless of size, can obtain the same discount when it serves a given end-user customer. This proposal has been before the Commission for three years, and no action has been taken on GTE's Petition. GTE urges the Commission to adopt a framework in which such volume discounts could be implemented without the need for a waiver.

E. Regulatory Roadblocks Must Be Removed In Order To Facilitate The Introduction Of New Services.

The Commission also should remove existing regulatory roadblocks in its access charge rules that impede the delivery of new access services. As GTE explained in its Access Charge NPRM Comments, the Commission should permit ILECs to introduce new access services without first making a public interest showing.[49] Such a result is supported by § 204 of the Act and sound policy concerns.

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[49] GTE Access Charge NPRM Comments at 51-54.

In the *Price Cap Third Report and Order*, the Commission allowed ILECs to introduce new services based on a "public interest" showing[50] and granted the ILECs permission to file a "me too" waiver as long as the basis for granting the original new service waiver was not predicated on competitive data.[51] Even under the new rules, however, an ILEC still must file a petition in order to introduce a new service.[52] In the *Access Charge NPRM*, the Commission asked whether it should eliminate all requirements that an ILEC obtain regulatory approval, including the public interest showing, before a tariff introducing a new service can take effect.[53]

Put simply, the *Third Report and Order* fails to provide adequate relief for the introduction of new services in today's dynamic and competitive telecommunications market. As the Commission itself recognized in the context of waiver requests, "requiring an incumbent LEC to file a waiver to introduce a new rate element imposes a costly, time-consuming, and unnecessary burden on incumbent LECs, and significantly impedes the introduction of new services."[54] The same holds true for filing a public interest petition.

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50 *Price Cap Third Report and Order* at ¶ 309.

51 *Id.* at ¶ 310.

52 *Id.* at ¶¶ 309-310.

53 *Access Charge NPRM* at ¶ 199.

54 *Price Cap Third Report and Order* at ¶ 309.

The requirements of the *Third Report and Order* are fundamentally inconsistent with § 204(a)(3) of the Act.[55] Under that section, access rates become effective on seven or fifteen days notice.[56] Any prior approval requirement — and indeed any Part 69 rate structure — necessarily violates the statutory streamlining. As the Commission states, "[b]ecause the underlying core access service offerings, as well as unbundled network elements, would still be available, there may be little benefit from requiring an incumbent LEC to obtain regulatory approval before introducing a new service."[57]

For the same reasons, the Commission should not adopt access charge rate structure rules for services using new technologies, such as ATM, SONET and AIN.[58] These technologies enhance the reliability and efficiency of networks and enable new transport and switched data services. Because CLECs and other carriers already make use of these technologies, market forces will require ILECs to adopt competitive rate structures and prices for such services. Moreover, the current rules allow ILECs to introduce new services at rates that exceed average variable cost.[59] Therefore, there is no need to further complicate the rules for introducing services based on new technologies, nor should the Commission try to force-fit new services into a rate

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55 *See* 47 U.S.C. § 204(a)(3) (1998).

56 47 U.S.C. § 204(a)(3).

57 *Access Charge NPRM* at ¶ 199.

58 *Access Charge NPRM* at ¶ 139.

59 *Policy and Rules Concerning Rates for Dominant Carriers*, 5 FCC Rcd 6786, 6816 (1990), *recon.*, 6 FCC Rcd 2637 (1991), *aff'd*, *National Rural Telecom Ass'n v. FCC*, 988 F.2d 174 (D.C. Cir. 1993) ("*Price Cap Second Report and Order*").

structure which has proven to be resistant to change. The purpose of the 1996 Act was deregulation, and that should be the intent of this proceeding. As explained in the following Section, the Commission should be eliminating the rigid Part 69 rate structure rules, and should not micromanage new services that are being introduced into a competitive marketplace.[60]

F. Additional Streamlining Should Be Adopted As Markets Satisfy Competitive Triggers.

As market areas satisfy reasonable competitive triggers, additional streamlining should be granted. In particular, the current complex and rigid scheme of price cap baskets and bands should be replaced with a simplified structure. Also in Phase II, the Commission should allow ILECs to enter into customer-specific contracts for access services. Contract-based pricing in competitive bidding situations is necessary to ensure low rates for consumers. The Commission has in the past conditioned a carrier's ability to provide contract tariffs and customer-specific pricing in response to requests for proposals on the existence of certain competitive conditions.[61] This type of regulatory constraint is unwarranted given the current state of competition for the large business customers that can stand to gain most from contract based pricing. All CLECs currently have the flexibility to offer customer-specific pricing. Denying ILECs the same

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[60] If the Commission nonetheless elects to prescribe a new rate structure, it must permit ILECs to recover the costs of implementing the new rate structure. A prime example of the need for such recovery is the proposal to recover certain SS7 costs on a usage-sensitive basis. *Access Charge NPRM* at ¶¶ 131, 133. Doing so would require the procurement and development of expensive new equipment.

[61] *Access Charge NPRM* at ¶¶ 195-196.

flexibility places them at a severe competitive disadvantage, which is inconsistent with the 1996 Telecommunications Act.

Under § 202(a) of the Act,[62] any such arrangements would have to be offered to any similarly-situated access customer. GTE is willing to comply with this type of requirement. This requirement both prevents discrimination and creates powerful disincentives to below-cost pricing. Contract-based arrangements will therefore promote, rather than impede, economically rational competition in the retail market.[63]

Finally, in Phase III of the USTA proposal, services would be removed from price cap regulation. This provision correctly relies on market forces to discipline prices where the ILEC is shown to lack market power. USTA properly recognizes that access markets differ in significant ways as a function of the size and type of customer being served. For large business customers, the choice of access provider is separable from the choice of local dial tone provider, while for residence and small business customers it may be necessary for the customer to have a choice of local service in order to have a choice of access provider. The USTA plan allows competitive triggers to be evaluated separately for these different market segments.

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62 47 U.S.C. § 202(a) (1998).

63 Compare this proposal with *Southwestern Bell Telephone Company*, 12 FCC Rcd 19311 (1997) (Southwestern Bell had proposed, in violation of Section 202(a), "a customer-specific offering not generally available to similarly situated customers.") *Id.* at ¶ 15.

GTE urges the Commission to begin its announced course of market-oriented access pricing reform and complete the job by adopting substantial pricing flexibility for ILECs now. Such measures will ensure that consumers receive the benefits of efficient pricing, send correct signals to new entrants and incumbents alike as to the true cost of providing access, and ultimately promote competition.

VI. THE COMMISSION SHOULD REFUSE TO INCREASE THE CURRENT X-FACTOR BASED ON THE OUTLANDISH DISTORTIONS OF ECONOMIC FACTS PRESENTED BY IXCs AND AD HOC.

A. The Commission Should Continue To Use Total Factor Productivity Based On Total Company Figures.

As GTE explained in its opposition to petitions for reconsideration filed by the Ad Hoc Telecommunications Users Committee ("Ad Hoc") and the AT&T Corp. ("AT&T"), the Commission should continue to rely upon total factor productivity, based upon "total company" data, as the basis for measuring LEC productivity for price cap purposes.[64] Modifying this approach to use "interstate only" data, as suggested by Ad Hoc and AT&T, would not only be unwarranted on the merits, but also would improperly exacerbate the already substantial and unlawful adverse impact of the new rules on GTE and other price cap carriers.

As GTE demonstrated, Ad Hoc and AT&T offer no basis upon which to depart from the Commission's repeated decision to set the X-factor based upon total company

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[64] GTE Price Cap Order Reconsideration Opposition at 10-12; GTE Price Cap Order Reconsideration Reply Comments at 4-5.

data rather than on interstate-only data.[65] Indeed, in its *Price Cap Order*, the Commission explained that "the record before us does not allow us to quantify the extent, if any, to which interstate productivity growth may differ significantly from total company productivity growth."[66] Previously, in the *LEC Price Cap Performance Review*, the Commission declined to set the X-factor based on interstate only data rather than total company data, explaining that:

> No party has argued that the production functions (the technological relationship between input and outputs) significantly differ for intrastate and interstate services in ways that can be readily measured or separated. Indeed, intrastate and interstate services are largely provided over common facilities. We therefore tentatively concluded that TFP should be calculated on a total-company, rather than interstate, basis. To the extent that parties can establish in the further notice that inclusion of intrastate performance data introduces a systematic downward bias in TFP, we believe it preferable to address such a problem directly, rather than attempting to construct an interstate factor based on regulatory accounting and other regulatory requirements that may not fully reflect economic costs.[67]

In their Petitions, Ad Hoc and AT&T merely repeat the same arguments that the Commission has considered and correctly rejected on two occasions.[68] The only other party to support these petitions, the American Petroleum Institute, provided no

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65 *Id.*

66 *Price Cap Order* at ¶ 110.

67 *Price Cap Performance Review for Local Exchange Carriers*, 10 FCC Rcd 8961, ¶ 159 (citations omitted) ("*1995 Price Cap Performance Review Order*").

68 Petition for Reconsideration of Ad Hoc Telecommunications Users Committee, CC Docket No. 94-1 and CC Docket No. 96-262 (filed July 11, 1997) ("Ad Hoc Price Cap Order Reconsideration Petition"); Petition for Reconsideration of AT&T Corp., CC Docket No. 94-1 and CC Docket No. 96-262 (filed July 11, 1997) ("AT&T Price Cap Order Reconsideration Petition").

justification for basing the X-factor on interstate-only data and presented no new arguments, asserting simply that the record provides ample support for granting AT&T's petition.[69] In contrast, Sprint provided an additional reason for refusing to base the X-factor on interstate-only revenues: Sprint anticipates that there will be a dramatic decrease in the per-minute-of-use-derived revenues, which will significantly slow LEC interstate productivity growth.[70] In light of the lack of record support for basing the X-factor on interstate-only data, the Commission should refuse to make such an arbitrary and artificial distinction and deny the petitions of AT&T and Ad Hoc.

In addition, the Commission also has specifically rejected AT&T's argument, raised anew in its Petition, that interstate productivity growth exceeds intrastate growth because the volume of interstate traffic overall is growing at a more rapid pace than is intrastate traffic.[71] In doing so, the Commission explained that, "[i]n light of the fact intrastate and interstate services share common facilities, the traffic growth differential alone does not establish that it is meaningful to distinguish two different measures of productivity."[72]

The Commission revisited this issue in its *Price Cap Order*, again concluding that "the record before us does not allow us to quantify the extent, if any, to which interstate

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69 Reply of the American Petroleum Institute ("API"), CC Docket No. 94-1 and CC Docket No. 96-262 at 2-3 (filed Sept. 3 1997) ("Reply of API").

70 Opposition of Sprint, CC Docket 94-1 and CC Docket No. 96-262 at 3-5 (filed Aug. 18, 1997) ("Opposition of Sprint").

71 *1995 Price Cap Performance Review Order* at ¶ 159.

72 *Id.* at ¶ 159 n. 309.

productivity growth may differ significantly from total company productivity growth" and that no party had provided "a factual or theoretical explanation as to why its assumptions might be correct."[73] Accordingly, the Commission again found "no basis in the record for making an adjustment to the X-Factor to account for any differences between interstate and total company productivity."[74]

In sum, AT&T has not offered any new factual or theoretical support for adjusting the X-factor to account for any differences between interstate and total company productivity at this time, nor can it.[75] Interstate-only estimates simply are inconsistent with total factor productivity methodology and theory. A properly conceived productivity offset contemplates all of the disparate factors affecting the unit cost of production and measures changes in aggregate efficiency of production. Use of interstate-only measurements, which by design are restricted to particular inputs and outputs, would thus be contrary to the Commission's current views on the economics of price caps. Any attempt to apply arbitrary separation rules in order to create factors that consider only interstate data would be capricious. Further, unless both input and output measurements can be meaningfully separated into interstate and intrastate as opposed to only output, as in the AT&T study, there can be no valid interstate-only TFP. In fact, AT&T even admits that inputs cannot be separated and simply assumes that it is

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73 *Price Cap Order* at ¶ 110.

74 *Id.*

75 *See* GTE Price Cap Order Reconsideration Opposition at 12-13.

rational to split inputs evenly between the jurisdictions.[76] Therefore, the Commission should decline to adopt AT&T's petition to reconsider the establishment of an interstate-only X-factor.

B. The X-Factor Is Currently Too High And Will Lead To Unreasonably Low Rates.

In its *Price Cap Order*, the Commission amended its price cap rules to raise the X-factor used to compute the PCI for price cap carriers to an unprecedented high level.[77] The Commission established a new X-factor of 6.0 percent, based on an arbitrary selection of data presented in the record, and continued adding a 0.5 percent Consumer Productivity Dividend ("CPD") with little explanation and no justification. These actions were arbitrary, capricious, unsupported by the record and otherwise unlawful, and have led to an X-factor that is too high and that will produce to unreasonably low rates. While GTE has addressed these issues in its pending appeal of the *Price Cap Order*, it will discuss them herein only insofar as necessary to allow it to "refresh" the record and to urge the Commission not to further increase the X-factor.[78]

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[76] AT&T Price Cap Order Reconsideration Petition at 9.

[77] *See generally Price Cap Order.*

[78] *See Initial Brief For Local Exchange Carrier Petitioners, United States Tel. Ass'n v. FCC*, No. 97-1469 (and consolidated cases) (D.C. Cir.) (filed April 30, 1998). GTE believes it must respond to the petitions for reconsideration filed by Ad Hoc and AT&T to protect its interests in the event the Commission were to act on the petitions for reconsideration before the Court acts on GTE's petition for review.

1. The Commission's X-Factor and CPD are irrational.

The record in the *Price Cap* matter and other proceedings makes clear that the X-factor is based upon manipulations of historical data, rather than on sound statistical analysis. For example, the baseline X-factor in the original and interim price cap plans was derived from the average of the short-term and long-term trends in rate reductions prior to its adoption of the original price cap plan in 1990, plus a CPD of 0.5 percent. In contrast, the Commission now has concluded that it should base its X-factor on a LEC total factor productivity-based measure of productivity and an input price differential.

Further, it should be self-evident that, in selecting a productivity estimate, the Commission should have relied on the ILECs' most recent experience under price caps rather than others' self-serving data and arguments. For example, although the Commission concluded that a fixed rather than a moving average approach would be preferable for setting the X-factor, it never explained why normal fluctuations in the economy should not be taken into account, especially when such fluctuations have a clear impact on ILECs' ability to increase productivity.[79] In addition, the Commission also failed to justify discarding productivity data that showed increases were lower than its preconceived estimates. In particular, the Commission disregarded both productivity figures from years it considered anomalous[80] and essentially the entire USTA

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79 *Price Cap Order* at ¶ 28.

80 *Id.* at ¶ 139.

productivity estimate.[81] Of course, such a systematic repudiation of all contrary evidence necessarily inflated the ultimate X-factor selected.

In addition, the Commission has failed to offer an evidentiary basis or justification for the CPD of 0.5 percent. There simply is no evidentiary basis for the CPD, and it is no longer necessary. Initially, the CPD was an arbitrary requirement added to the productivity offset to ensure that the initial benefits of price cap regulation were passed on to consumers. Today, eight years after the implementation of price caps, this argument is surely obsolete. Because the Commission has adopted a fundamentally different – and according to the Commission, more accurate[82] – methodology than that used under years of price cap regulation, the agency's alternative justification for the CPD is equally obsolete. The Commission adopted the CPD in order to compensate for any underestimated productivity gains not accounted for in its methodology used to calculate LEC productivity growth.[83] The Commission's conclusion that a CPD is still required to "replicate the results of a competitive market" is untenable.[84]

2. Current data on LEC productivity demonstrates that the 6.5 percent figure is already too high.

In its Comments, USTA has compiled new economic analysis that demonstrates that the Commission's current X-factor is too high.[85] Even using the Commission's own

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81 *Id.* at ¶ 137.

82 *Id.* at ¶ 1.

83 *See Bell Atlantic v. FCC*, 79 F.3d 1195, 1198 (D.C. Cir. 1996).

84 *Price Cap Order* at ¶ 124.

85 *See generally* USTA Comments.

productivity model and data from 1996 and 1997, USTA found that the X-factors estimates for 1996 and 1997 are 2.1% and 4.1% respectively.[86]

Consistent with USTA's observations, this newly developed data leads to the important conclusion that the Commission's 6.0% X-factor amounted to a statistical "peak" rather than a component of an "upward trend" as claimed by the agency.[87] USTA's economic analysis further confirms that a comparison of revised moving averages reveals a downward trend in X-factor averages, suggesting that such a trend may have begun before the 1997 and 1998 timeframe.

Moreover, considering this data using USTA's Total Factor Productivity Review Plan provides further support that the Commission's current X-factor is too high. An update of USTA's model with the 1996 and 1997 data indicates a five-year moving average X-factor ranging from 2.7% to 3.0%.[88] USTA's model measures the growth in the demand actually realized (output) less the growth in resources actually used (inputs). Unlike the models relied upon by AT&T and MCI, the USTA model relies upon data which are publicly available and verifiable.[89]

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86 *See generally* USTA Comments at 16. GTE does not endorse the Commission's model, which is riddled with errors and distortions. However, it references this new data by way of example to demonstrate that even the Commission's own model leads to an inaccurately high X-factor.

87 *Price Cap Order* at ¶ 141.

88 *See generally* USTA Comments.

89 *See generally* USTA Comments.

C. The Commission Should Not Further Manipulate The X-Factor Based Upon the Political Goal of Reducing Access Charges.

As GTE and others have asserted in their appeal of the Commission's *Price Cap Order*, the Commission arbitrarily relied upon a manipulation of relevant data to reach its desired end. As noted above, the Commission disregarded both productivity figures from years it considered "anomalous"[90] and essentially the entire USTA productivity estimate.[91] Also, it found a "strong upward trend" where none existed and relied selectively on AT&T's results to justify increasing in the upper bound of the "range of reasonableness" to 6.3%.

The Commission should decline to manipulate the X-factor further based on the political goal of reducing access charges. While arguably an "appealing" alternative from the standpoint of expediency, such a result cannot be supported on either a legal or policy basis. Any such attempt would be economically unsound, undermine price cap incentives, and hinder competition.

VII. GTE SUPPORTS MCI's CALL FOR ELIMINATING THE DISTINCTIONS BETWEEN PRIMARY AND NON-PRIMARY RESIDENTIAL LINES.

As GTE has previously cautioned in its Comments and Reply Comments in CC Docket No. 97-81, the wholly arbitrary distinction between primary and secondary lines is replete with uncertainty, confusion, and potential abuse.[92] Without exception, each

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90 *See Price Cap Order* at ¶ 139.

91 *See Price Cap Order.* at ¶ 137.

92 *See* Comments of GTE, CC Docket No. 97-181 (filed Sept. 25, 1997); Reply Comments of GTE, CC Docket No. 97-181 (filed Oct. 9, 1997). *Defining Primary Lines,*

attempt to define a primary residence line in some way places the ILEC in the patently absurd position of trying to define such things as a customer's lifestyle, living arrangement, or social relationships. Accordingly, the Commission should eliminate the distinction between primary and non-primary lines for purposes of access rate application and for the calculation of universal service support.

GTE agrees with MCI that distinguishing between primary and non-primary lines does not produce a benefit remotely commensurate with its costs. The Commission should immediately move to eliminate this arbitrary distinction. If the Commission were to grant this portion of MCI's Petition, many of the remaining implementation issues raised by MCI would be moot. IXCs would no longer need to be concerned with timely, verifiable, auditable line count information supporting primary and non-primary PICC charges.

The concerns raised by the artificial distinction between primary and non-primary lines extend well beyond matters of administration. Because the distinction drawn among lines is arbitrary, so too is the difference in price which results from this distinction. Non-primary lines are made to seem artificially expensive to consumers, for reasons they, quite reasonably, find difficult to understand and to accept. While no one would claim that the current prices for basic local service reflect the cost of service, the Commission does nothing to correct these price signals by introducing yet another price distortion between primary and non-primary lines. Certainly the difference in price does not reflect any difference in cost. If the Commission believes that end-users should

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Notice of Proposed Rulemaking, CC Docket 97-181, FCC 97- 316 (rel. Sept. 5, 1997).

bear a larger proportion of loop costs, then it should increase subscriber line charges accordingly. If the resulting charge is found to be unaffordable for customers in some areas, then this should be addressed through universal service support, not by artificial distinctions in how the charge is applied.

Indeed, if the artificial distinction between primary and non-primary lines is applied in the context of the Commission's federal high cost funding mechanism, the resulting rate distortion will become even more unreasonable. If a customer in a high cost area finds it difficult to accept that a non-primary line should cost an additional $1.50, the customer will be even more perplexed to discover that the primary line costs $12 per month, while the non-primary line, in the absence of universal service funding, costs $70 per month. Quite aside from the obvious problem of customer acceptance, it is simply poor policy to create such a large rate difference between two lines whose underlying costs are essentially the same. Customers' service choices, as well as their choice of carrier, will be unreasonably distorted by this entirely artificial price difference.[93]

If the Commission refuses to remove the distinction, it should adopt a standardized, independently verifiable definition of primary and non-primary residential lines. Without an independent means by which to distinguish between lines, IXCs will continue to question ILECs about the number of non-primary lines reported and will continue to allege that there is no way to verify the accuracy of their PICC bills. On the

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[93] Customers' choice of local carrier will be affected because it will not be possible to prevent customers from ordering primary lines from different carriers in order to escape the unreasonable difference in price that would result if more than one line is ordered from the same carrier.

other hand, ILECs will continue to spend millions of dollars answering IXC questions – for which no answer will be acceptable – and they will spend additional millions of dollars explaining to customers why their particular lifestyles result in one or more of their lines being classified as non-primary and subject to higher costs. Such an outcome is counterproductive to the goal of efficient access reform and should be eliminated.

VIII. CONCLUSION

As set forth herein, the Commission's response to the "refreshed record" in this proceeding should be three-fold:

First, the Commission should adopt a federal universal service plan sufficient to replace the universal service support generated today by interstate access. USTA has recently proposed a plan for nonrural ILECs that would address the implicit support provided by CCL and PICC rates. GTE supports this proposal, but notes that additional support flows generated by the current rates for switching and transport are not addressed by the USTA plan.

Second, the Commission should allow ILECs to price their access services flexibly. This framework should immediately allow ILECs, subject to reasonable safeguards to: (1) geographically deaverage prices of all access elements; (2) offer volume and term discounts; and (3) offer new access services with fewer impediments. The framework should also establish an orderly process for further streamlining of the Commission's access regulation as reasonable competitive triggers are reached. GTE supports USTA's proposal which provides a sound basis for this regulatory framework.

Third, the Commission should eliminate the arbitrary distinction between primary and non-primary residential lines because that distinction distorts competition by creating unreasonable distinctions in customer pricing and universal service support and is burdensome to administer.

Respectfully submitted,

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October 26, 1998