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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington D.C.

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 THE
UNITED STATES TELEPHONE ASSOCIATION

Its Attorneys:

Lawrence E. Sarjeant
Linda L. Kent
Keith Townsend
John W. Hunter

1401 H Street, NW, Suite 600
Washington, D.C. 20005
(202) 326-7248

October 26, 1998

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SUMMARY

In updating the record as requested by the Commission, USTA submits the following: switched access rates have steadily decreased since price cap regulation was introduced and will continue to do so without prescriptive rate cuts; no economic or policy rationale supports a prescriptive approach to access pricing and uneven growth in competition or recent court decisions do not alter that fact; updating both the FCC and USTA productivity models with data from 1998 and 1997 reveals that the upward trends which the Commission predicted to justify the current 6.5 percent X-Factor did not materialize and thus the current factor is too high and must be lowered; future opportunities to achieve an X-Factor of 6.5 percent are diminished; the CPD has outlived its purpose and must be eliminated; an 'interstate only' X factor is economically meaningless and must not be adopted; reinitialization of price cap indices is unjustified; the major IXCs have not passed through reductions in access charges to residential customers; a mechanism whereby regulation of access is reduced when competitive triggers are met is long overdue and should be implemented as recommended in USTA's proposal; and, competition in interstate access markets by CLECs continues to grow at unprecedented rates.

In support of these findings, USTA has attached an economic analysis of the current status of the interstate access market prepared by Dr. William Taylor of the National Economic Research Associates. Dr. Taylor also analyzes USTA's proposal to introduce competitive triggers to signal reduced regulation and concludes that the proposal meets economic criteria. USTA also provides its analysis of switched access prices and earnings and investment data. This data shows that switched access rates will continue to decrease. However, if USTA's universal service proposal is adopted the decrease accelerates. Other data provided demonstrates

that earnings levels, which are not relevant under price cap regulation, are modest compared to other corporations, despite continued high investment in telephone plant. Dr. Taylor notes that if increased earnings come to be interpreted as a failure, price cap regulation is little more than rate of return regulation.

Professor Frank Gollop of Boston College provides an assessment of the update of the FCC and USTA productivity models and verifies the results. Those results clearly indicate that the 6.5 percent X-Factor must be lowered:

Averaging Period	Update of FCC Model Average X	USTA Average X
1991 - 1995	5.0%	2.7%
1992 - 1996	4.2%	3.2%
1993 - 1997	4.4%	3.0%

These finding indicate that the transition to the market-based approach to access pricing should continue and the Commission should reject, once and for all, any consideration of prescriptive access rate cuts. In order to facilitate the positive trends which incentive regulation has provided and to complete the pro-competitive, deregulatory framework, USTA recommends that the Commission act immediately to implement USTA's universal service proposal for non-rural carriers, implement USTA's proposal regarding competitive triggers, lower the X-Factor and release the promised proceeding on historical cost recovery.

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The United States Telephone Association (USTA) respectfully submits its comments in the above-referenced proceedings. USTA is the principal trade association of the local exchange carrier (LEC) industry. Its members provide over 95 percent of the incumbent LEC-provided access lines in the U.S. Its members include the incumbent LECs subject to price cap regulation.

In a Public Notice released October 5, 1998, the Commission asked parties to update and refresh the record on access charge reform, price cap regulation, prescription of access rates and access pricing flexibility for price cap companies.

I. INTRODUCTION AND SUMMARY.

In fulfilling its obligation to develop and institute a pro-competitive, deregulatory national telecommunications policy framework, the Commission has concentrated its efforts on

establishing the conditions to facilitate the development of competition. It is time for the Commission to give equal attention to the deregulatory portion of the policy framework, for as competition continues to develop, there is less need for many of the current rules and regulations, and a greater opportunity and obligation to rely on market forces instead of regulation. There is much work to be done. Since the Commission failed to implement the market-based approach, the lack of experience with a mechanism to reduce regulation once competitive triggers are met makes concerns regarding the development of competition premature. In addition, the Commission has not addressed the recovery of historical costs and has not yet implemented a universal service plan that would make explicit the current flow of implicit support from interstate access charges. The Commission should lay to rest any further discussion of prescriptive access rate cuts and complete this work.

The Commission adopted its access reform and price cap orders in May 1997.[1] In updating the record of the inter-related proceedings listed above, USTA concludes the following:

*Incentive regulation continues to work by replicating the competitive marketplace resulting in lower switched access rates, which have fallen steadily since price cap regulation was introduced and which will continue to do so without prescriptive access rate cuts;

*No evidence exists to justify a prescriptive cut in access charges;

*Updating the FCC and the USTA productivity models shows that the trends which the Commission predicted would justify the current X-Factor of 6.5 percent did not materialize and thus, the current factor is too high and must be lowered;

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[1]Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing, End User Common Line Charges, CC Docket Nos. 96-262, 94-1, 91-213, 95-72, *First Report and Order*, FCC 97-158 (rel. May 16, 1997) and Price Cap Performance Review for Local Exchange Carriers, Access Charge Reform, *Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262*, FCC 97-159 (rel. May 21, 1997).

*Future opportunities to achieve an X-Factor of 6.5 percent continue to diminish;

*The CPD has outlived its purpose and must be eliminated;

*USTA has developed a mechanism whereby regulation for access services would decrease when certain competitive triggers are met which will facilitate economically efficient pricing, entry and investment in the telecommunications market;

*The major IXCs have not passed through reductions in access charges to residential customers; and,

*Competition in interstate access markets by CLECs continues to grow at unprecedented rates.

These findings indicate that the transition to the market-based approach should continue and the Commission should reject, once and for all, any consideration of prescriptive access rate cuts. In order to perpetuate the positive trends which incentive regulation has provided and to complete the pro-competitive, deregulatory telecommunications framework, the Commission should act immediately to implement USTA's universal service proposal for non-rural carriers, implement USTA's proposal regarding competitive triggers, lower the X-Factor, and release a proceeding on historical cost recovery.

II. PRICE CAP REGULATION WHICH REPLICATES THE EFFICIENCIES OF COMPETITIVE MARKETS ALREADY CAPS ACCESS RATES AND ASSURES DECREASES IN ACCESS PRICES.

There is no logical reason to overturn the incentive-improvement benefits of price cap regulation and take a giant leap backward. As Dr. William Taylor, National Economic Research Associates, explains in Attachment A, the purpose of price cap regulation was to improve the incentive effects of cost-based rate of return regulation and move to a regulatory system that is compatible with competition. As competitive forces replace regulatory forces in controlling prices, price cap regulation is intended to transition away, neither advantaging nor

disadvantaging regulated firms in competition with entrants.

Price cap regulation provides incentives for companies to become more efficient through the promise of increased profits, at the same time capping prices. So far, price cap regulation has worked well to reduce access rates and will continue to do so in the future without prescriptive rate cuts. The two charts included in Attachment B show the decline in switched access rates since price cap regulation was implemented in 1990. On Chart 1, USTA has projected that rates will continue to decrease over time, reaching approximately $.01 per minute of use in 2003. Chart 1 also shows that flat rate charges will begin to decline in 2000. Clearly, the Commission's access reform decision to restructure access charges by transitioning away from usage-based charges has facilitated the rapid movement of rates to more economically efficient levels. USTA's analysis also reveals, as depicted on Chart 2 of Attachment B, that since a significant portion of current access charges are directly related to implicit support, adoption of USTA's universal service proposal for non-rural incumbent LECs to recover a portion of implicit support from the Universal Service Fund will drop the minute of use rate to about $.01 immediately and will result in an immediate reduction in flat rate charges due to the elimination of the PICC.[2] The current flow of implicit universal service support from access should not be eroded by competition for switched access, and certainly not by prescriptive reductions in access rates. The Commission should continue with the approach it adopted in the access charge order and adopt USTA's universal service proposal.

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[2]USTA, "Preserving Universal Service in Competitive Markets for Non-rural Carriers", Cite ex parte of plan.

Under incentive regulation, earnings levels should be completely irrelevant, but the major IXCs have cited the level and growth of accounting earnings as support for a prescription of access charges or an increase in the productivity factor.[3] Earnings levels for price cap companies have achieved significant efficiency improvements in response to the opportunities under incentive regulation and have benefitted from a strong U.S. economy. Again, the incentives of the price cap plan are working. However, the growth is not as dramatic as the IXCs have claimed, particularly when compared to other U.S. corporations, as illustrated in the charts included in Attachment C. Since price cap regulation was introduced in 1991 through 1997, the total price cap carrier interstate earnings have grown at a 5.2 percent annual rate. Overall earnings growth rates for U.S. competitive firms has been higher during that time frame. Total earnings for all U.S. non-financial corporations and the Value Line Industrial Composite of 752 companies rose at an annual rate of 17 and 12 percent respectively. (See comparison at Attachment C, Chart 1).

Despite the fact that earnings are modest compared to other U.S. corporations, incumbent price cap LEC investment in telephone plant is higher than ever, exceeding $20 billion annually.(Attachment C, Chart 2). Chart 3 shows that the annual level of BOC telephone investment, for example, represents 23 percent of revenue. This compares favorably with other firms such as the Value Line Industrials Composite, whose earnings are growing faster than that of the incumbent LECs. The Commission must avoid actions that would diminish the attractiveness of the incumbent LECs to investors. Dr. Taylor observes that if increased earnings

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[3]*See*, USTA response in a Letter from Lawrence E. Sarjeant to Mr. A. Richard Metzger, CC Docket Nos. 94-1 and 96-262, May 29, 1998.

come to be interpreted as a failure of price cap regulation, then price cap regulation will become little more than rate of return regulation. Increased reported earnings should not trigger regulatory retaliation or all of the beneficial incentives of price cap regulation will be lost. Prescriptive access rate cuts would undermine the abilities of incumbent LECs to generate competitive financial market returns.

Of course, the positive market trends experienced by incumbent LECs are overshadowed by the dramatic growth in competition from competitive LECs (CLECs). CLECs include traditional long distance carriers, competitive access providers, wireless carriers, utility companies and incumbent LECs. Utilizing either their own facilities, UNEs, resale or a combination thereof, they directly compete with the incumbent in the provision of access services and indirectly compete by displacing the incumbent as the provider of local services. CLECs are well positioned to take advantage of the removal of all barriers to the local telecommunications market because they are largely free from regulatory requirements at both the state and federal levels. The number of CLECs now exceeds the number of incumbent LECs in the U.S. having grown over 250 percent since the access reform order was adopted.[4] According to a survey conducted by *State Regulation Report*, as of July 31, 1998 there are 1,429 CLECs holding 2,844 competitive local exchange certificates issued by state regulators compared to 1,332 incumbent local telephone companies.

Most financial analysts agree that CLECs will continue to capture significant portions of the local telecommunications market. In fact, by the first quarter of 1998, CLECs had added

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[4]"Number of CLECs in U.S. Now Exceeds Total of Incumbent Telcos," *State Telephone Regulation Report*, Vol.16, No. 19, September 18, 1998 at 1.

more business lines than the BOCs.[5] The Solomon Smith Barney report notes that CLECs as a group have achieved in less than two years after the Telecommunications Act of 1996 opened local markets what it took MCI over ten years to achieve during the 1970s and 1980s.

CLECs today are averaging a yearly growth of 100 percent in switched services and this trend will continue as CLECs continue to add switches and cities to their networks.[6] Merrill Lynch's review of second quarter 1998 CLEC results continues to show strong revenue growth, driven by net access line additions and increasing penetration of data services. "On whole the CLEC group continues to invest heavily in data networks which help to expand the portfolio of services offered to customers and 'jump start' commercial operations in new markets."[7] GST Telecommunications, based in Vancouver, Washington, which provides integrated telecommunications services, including private-line, local dial-tone, long distance, Internet and enhanced data services, throughout California and the western U.S. provides an example of the dramatic CLEC growth. Based on third quarter 1998 results, GST had accelerated its installation of lines by over 36 percent in one quarter. 98 percent of the lines installed were provisioned on the company's own fiber network or through unbundled loops or other leased facilities. Only two percent of the lines were provisioned through resale.[8]

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[5]Salmon Smith Barney Report, "CLECs Surpass Bells in Net Business Line Additions for First Time", May 6, 1998.

[6]NationsBanc Montgomery Securities, "Telecommunications Services Industry Overview: Competitive Local Exchange Carriers", September 1998.

[7]Merrill Lynch, "Telecom Services — Local", September 22, 1998.

[8]Bear, Stearns & Co., "First Glance at 3Q98 CLEC Results Looks Good", October 9, 1998.

The mergers of the largest CLECs and IXCs, WorldCom/MCI and AT&T/TCG, will allow these new companies to self-provision access services. WorldCom, which previously acquired MFS and Brooks Fiber, is expected to provide MCI with more than 70 percent of its access capacity.[9] AT&T's purchase of TCG is expected to result in significant network access savings.[10]

The success and increasing strength of the CLEC industry is a testament to the amount of competition that exists in the local telecommunications market. The impact of this competition on the incumbent price cap LECs has been documented in all of the proceedings captioned above and in the voluntary reports which many have been providing to the Commission regarding the status of local competition. For example, in its September 1, 1998 submission, SBC noted that it had lost over *one million* lines to CLECs.[11] BellSouth reported that in March of this year, approximately eighty percent of the facility-based wireline CLEC access lines were provisioned over CLEC facilities without the use of BellSouth-provided UNEs.[12] Obviously CLECs are building significant infrastructure in many areas. Of course, a complete picture of the status of local competition cannot be discerned without comparable data from the CLECs themselves.

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[9]Salomon Smith Barney, "WorldCom, Inc. Company Report," April 9, 1998.

[10]Prudential Securities, "AT&T Company Update," January 21, 1998.

[11]Ex Parte Letter from Todd F. Silbergeld, CC Docket No. 97-121, September 1, 1998.

[12]Letter from Whit Jordan to A. Richard Metzger, Jr., March 13, 1998.

Evidence on competition also clearly shows that CLECs are targeting the lucrative business customers and bypassing residential customers.[13] Competition for residence and single line business customers is developing slowly. In an article published earlier this year, Dr. Alfred Kahn addressed this issue. He explained that, because of the historical policy of subsidizing basic local residential rates by overcharging for long distance and service to large businesses,

> [i]t shouldn't be surprising that competitors are unwilling to incur the costs of leasing or building facilities to compete for services that are priced below cost...[Large business] rates have been set far above cost, to subsidize residential rates, every major metropolitan area in the country now has competitive providers of access for long-distance calls, most of which now offer complete service to business customers. These services are so widely available in New Jersey that the [public service] board effectively deregulated the high-capacity market a decade ago...[I]f the local companies could forestall competition...they would surely have done so most stubbornly and successfully in the sale of these highly profitable business services. Significantly, the leaders in this competition for business services historically have been independent new entrants like MFS and Teleport, not the major long distance carriers. The latter companies have their own reasons for delay: every day they hold back is a day they can argue that the Bell Companies should continue to be prohibited from competing with them in the long-distance business because they have not opened their local markets.[14]

The price distortions Dr. Kahn describes cannot be addressed through arbitrary reductions in access rates. Access rates have been set at their current levels in order to support affordable local service. This policy attracts competitors to serve business and high volume residence customers, and discourages entry into markets for residence local service. To correct these price signals, the Commission should remove implicit support from access charges and associate it

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[13]*See*, Peter Huber, Kellogg, Huber, Hansen, Todd & Evans, "Local Exchange Competition Under the 1996 Telecom Act: *Red-Lining the Local Residential Customer*", November 4, 1997.

[14]Alfred E. Kahn, "SoapBox Hung Up", *The New York Times*, August 30, 1998 at 13.

with local service by incorporating it into universal service. If portable, it would provide proper incentives for CLECs to enter local markets and compete for residence customers.

The growth of the local telecommunications market even in the past year should be viewed positively as evidence that the Commission need not alter its course by adopting a regressive prescriptive policy. The evidence demonstrates that it is time to move forward to implement a universal service mechanism as proposed by USTA and implement the market based approach for switched access rates, including sufficient pricing flexibility so that market forces guide access prices and network investment.

III. PRESCRIPTION OF ACCESS RATES REPRESENTS BAD ECONOMIC AND PUBLIC POLICY.

A. The Current Record Repudiating a Prescriptive Approach Has Not Been Refuted by Either MCI or CFA.

In a statement attached to USTA's reply comments in CC Docket No. 96-262, Dr. Kahn declared that the Commission's suggested prescriptive approach to the reform of carrier access charges, taken in conjunction with its previous order on local interconnection policy,

> would, in my judgment, jeopardize achievement of the ultimate goal of the Telecommunications Act--namely, accelerated development and investment in an advanced telecommunications infrastructure, under conditions of efficient, dynamic competition. It would do so by reducing carrier access charges rapidly in the direction of total service long-run incremental cost, not of the companies themselves but of a hypothetical entrant. The prescriptive approach ignores the costs of the incumbent local exchange companies, both historical and current, including the costs of the continuing regulatorily-required underpricing of basic residential service. By so doing, it undermines both the incentives and the ability of the ILECs to engage in the necessary large investments in the public network, on which we will continue to be heavily dependent in the years immediately ahead, while at the same time diluting the incentive of new competitors to enter on a facilities basis. The prescriptive approach would also have particularly damaging effects on the incentive of the ILECs and potential challengers to

> engage in creative innovation. It will do these things, evidently, in the belief that the markups above incremental costs contained in the current capped access rates constitute a barrier to efficient competition at both local and interLATA levels. That belief is erroneous.[15]

In addition, Sidak and Spulber, in a separate affidavit, stated that the prescriptive approach would deny incumbent LECs any reasonable opportunity to recover its total costs and would constitute a taking of property in violation of the Fifth Amendment.[16]

Finally, Schmalensee and Taylor stated that the prescriptive approach constitutes a return to cost-based rate of return regulation and a reversal of the incentive-improvement intentions of price cap regulation.[17] Such an approach would required detailed Commission intervention in the exchange access market and accurate forecasts of long-run competitive prices, a process that carries with it significant costs and risks of error, particularly in markets in which competition is present. They asserted that while market forces and the requirements imposed by the Telecommunications Act will continue even under a prescriptive approach, such factors will make the prescriptive approach even more difficult to sustain. At best, the prescriptive approach will become irrelevant, at worse the prescriptive approach will confound desirable market forces.[18]

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[15]Alfred E. Kahn Statement at 2, USTA Reply Comments, CC Docket No. 96-262, February 14, 1997 at Attachment 1.

[16]Affidavit of J. Gregory Sidak and Daniel F. Spulber, USTA Comments, CC Docket No. 96-262, January 29, 1997 at Attachment 3 and Reply Affidavit, USTA Reply Comments, February 14, 1997 at Attachment 2.

[17]Indeed, a prescriptive approach based on a cost-model estimate would constitute a return to fair value regulation, which was abandoned sixty years ago.

[18]Richard Schmalensee and William E. Taylor, "Economic Aspects of Access Reform", (continued...)

Nothing has changed since these economists analyzed the Commission's prescriptive proposal which would even suggest that prescriptive access rate reductions should be imposed. A prescriptive approach would clearly be premature when the Commission has not yet acted to replace the implicit universal service support in switched access rates.

The Commission appropriately rejected the prescription approach advocated by some parties to require a reinitialization of the PCI based on the currently authorized rate of return. "They favor reinitialization largely because they believe interstate access charges should be lower than they are now...We believe that rate of return-based reinitialization would have substantial pernicious effects on the efficiency objectives of our current policies...[that suggestion] would undermine productivity incentives by imposing the greatest penalties (rate reductions) on those carriers that had improved their productivity the most."[19]

The Commission properly recognized that time was needed for competition to continue to develop and for incumbent LECs to implement the market-based approach. Of course, the Commission has yet to establish the appropriate triggers to permit pricing flexibility where competition exists. Thus, it is grossly premature to conclude that the market-based approach is not successful, since it has yet to be fully implemented, and that a prescriptive approach must be employed. The Commission declared that it would take at least three years to give competition sufficient time to develop substantially and that it would be "imprudent to prejudge" the

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[18](...continued)
USTA Comments, CC Docket No. 96-262, January 29, 1997 at Attachment 1 and USTA Reply Comments, February 14, 1997 at Attachment 3.

[19]Access Reform Order at ¶¶ 291, 292 and footnote 391.

effectiveness of the market opening measures that had recently been adopted.[20] The Commission also recognized that time was needed to take into account the effects of the substantial rate structure changes that were adopted. Of course this will be more difficult to assess since the Commission recently delayed the next phase of PICC increases.[21]

B. Uneven Growth in Competition Does Not Justify Prescription of Access Rates.

Clearly prescriptive access rate cuts are anathema to the pro-competitive, deregulatory framework required by the Telecommunications Act and would represent a giant step backward from incentive based regulation by disrupting the transition to competition. In his press statement accompanying the release of this Public Notice, Chairman Kennard noted that pursuit of a deregulatory competitive environment must be tempered by evidence that growth in competition among access providers has been sporadic and uneven. The Commission addressed this point in its access reform order. The Commission recognized that competition is likely to develop at different rates in different locations and that some services will be subject to competition faster than other services.[22] The Commission explained that this was completely consistent with the profit-maximizing incentives of new entrants. New entrants are expected to serve the most profitable, higher priced customers first, for the reasons articulated by Dr. Kahn. As competition develops for serving these customers, the margins for serving them decrease. Over time, the relative profitability of serving lower-priced customers increases and competition

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[20] Access Reform Order at ¶¶ 268 and 269.

[21] *Third Order on Reconsideration*, CC Docket No. 96-262 (October 1, 1998).

[22] Access Reform Order at ¶ 266.

develops for those customers as well. However, it takes time for these market phenomena to occur. That competition may develop in an uneven or sporadic manner is not a failure of the efficiency of the market. It is the rational operation of market dynamics. Different rates of competitive growth reflect different rates of competitive entry which in turn reflect different profit margins in different services and customer markets. Prescriptive rate cuts are not the solution to uneven competition. A market-based approach will facilitate rates which are economically efficient.

C. Court Decisions Do Not Justify a Prescriptive Approach.

Others have claimed that the decisions of the 8th Circuit Court of Appeal have threatened the development of competition and require a return to prescriptive regulation. This claim is unfounded for numerous reasons. First, the decisions of the 8th Circuit, on appeal to the U.S. Supreme Court, clarified the jurisdictional responsibilities of both the Commission and the states regarding the pricing rules for unbundled network elements (UNEs). The Court had stayed the Commission's pricing rules long before the Commission adopted the access reform order. Thus, the Commission was aware that the rules for UNE pricing were far from settled at the time of the access charge proceeding. Further, there is nothing in the Order to suggest that the Commission relied on rebundling of UNEs to support the market based approach.

Second, there is no evidence to conclude that the Court's decisions undermined the Commission's decision since the majority of states have adopted the Commission's recommended pricing rules based on forward-looking cost methodologies for UNEs and some states have required combinations of elements available at forward-looking prices. States have also approved resale discounts in the default range specified by the Commission.

Third, the Commission never relied on the availability of UNEs as the sole basis for the development of competition. The Act and the Commission sought also to encourage facilities-based competition and resale. Facilities-based competition for access has been developing for several years, prior to the development of competition for local dial-tone service. Large business customers, who represent a substantial proportion of the demand for access, are able to obtain access to IXCs through alternative sources, such as the fiber optic networks which have now been built in many areas around the country. For these customers, the choice of access provider is separable from the choice of local service provider.

Fourth, as discussed by Schmalensee and Taylor, the existence of interconnection agreements with UNEs at forward-looking rates make many incumbent LEC customers potential competitive LEC customers, constrained only by the latter's ability to convince customers to switch access providers.[23] Customers are vulnerable to competitors because, once they win the customer, UNEs can be used as substitutes for incumbent LEC-provided access services as well as for retail local exchange services. Schmalensee and Taylor conclude that the existence of interconnection agreements should give the Commission a sense of urgency to act to grant pricing flexibility.

Fifth, as discussed above, competition was developing long before the passage of the Telecommunications Act in 1996 and the voluminous data which has been provided to the Commission over the past two years clearly shows that competition for access services has

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[23]Richard Schmalensee and William Taylor, National Economic Research Associates, "The Need for Carrier Access Pricing Flexibility in Light of Recent Marketplace Developments: A Primer", USTA Comments, CC Docket No. 97-250, March 18, 1998 at Attachment.

developed, that incumbent LECs have opened local markets to competition and that competition continues to increase.

D. There is No New Economic Rationale to Support Prescription.

There is certainly no new economic justification for prescriptive access rate cuts. Dr. Taylor, in Attachment A, discusses how prescriptive regulation undermines the incentives in price caps, destroys regulatory credibility and disrupts long run market dynamics. As a result, incentives to increase investment and improve efficiency are defeated. The latter point is described by Dr. Kahn in his latest book. "The likely depressing effect on investments in upgrading the public network of the recommended cut in access charges, uncompensated elsewhere, as well as of the FCC's proposed rates for network elements, is not confined to their effect on the *incentives* of both incumbent and competitive LECs. Even more directly and obviously, a reduction in the flow of revenues to them...could not but diminish drastically the *ability* of the former companies to finance such investments."[24]

> What is particularly troublesome about the FCC's proposals is that its conception of the prerequisites for achieving efficiency is entirely *static*, while competition--especially in telecommunications--is inherently dynamic. Any proposal that rates be set at costs, or costs plus regulatorily-prescribed markups, should at least, in consideration of the critical importance of innovation, distinguish the rules applicable to existing network elements or to sales of existing retail services for resale from the rules that would apply to new ones. To tie the rates for new services closely to costs, incremental or otherwise, would fatally attenuate the incentives of incumbents to develop new and innovative

[24]Dr. Alfred E. Kahn, "Letting Go: Deregulating the Process of Deregulation", Michigan State University Public Utility Papers, 1998 at 108.

services as well as of competitors to enter on a facilities basis.[25]

Moreover, there is no economic basis for driving prices to incremental cost. As Dr. Taylor explains, for a multi product 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. Dr. Kahn concurs, "[i]n unregulated markets, prices tend to be set on the basis of the actual costs of incumbent firms, and they should be...such prices give challengers the proper target at which to shoot--the proper standard to meet or beat and the proper reward if they succeed. If they can achieve costs lower than that, they will enter and *in the process* (which the FCC's pricing rules would omnisciently short-circuit) beat prices down to efficient levels. In contrast, TELRIC-based charges...would actually discourage competitors coming in and building their own facilities, which it was the clear intention of the new Act to encourage."[26] Dr. Taylor expands on that point noting that as rates are cut, there is less potential return for a carrier that builds competing facilities. As explained above, rebalancing rates by replacing implicit universal service support in switched access will provide better economic price signals for entrants to invest in both business and residence local markets. However, even after rebalancing, prescriptive access charge reductions would provide poor entry signals because such prices do not reflect their full economic costs. Dr. Taylor notes that what is needed is deaveraged prices, not across-the-board non-economic reductions imposed by regulatory fiat. Dr. Taylor concludes that allowing market forces to determine the mechanism to recover shared and common costs

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[25] *Id.* at 102.

[26] *Id.* at 96.

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

No firms will be encouraged to become facilities-based competitors if the costs necessary to invest in the infrastructure cannot be recovered because prices do not reflect market conditions. Chilling incentives to invest in the infrastructure through a prescriptive cut in access rates will threaten the maintenance of high quality, reliable service, stifle innovation and jeopardize universal service. It is clear from the record in CC Docket No. 96-262, that competitive LECs shared these concerns as many, including Time Warner, TCG and ALTs, supported the market-based approach and opposed prescriptive access reductions.

E. Prescriptive Access Rate Cuts Will Not Benefit Consumers.

There is no evidence to date that prescriptive access rate cuts will provide any benefits other than to provide a windfall to the major interexchange carriers (IXCs) who, not only fail to pass through any reductions in interstate access prices to residential customers, but are actually increasing residential long distance rates. In studies recently completed by the National Economic Research Associates (NERA), despite a reduction in the costs of serving residential customers, the three largest IXCs increased residential long distance rates from 1997 to April 1998.[27]

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[27]Paul S. Brandon and William E Taylor, "Assessment of AT&T's Study of Access Charge Pass-Through" and "AT&T, MCI and Sprint Failed to Pass Through the 1998 Interstate Access Charge Reductions to Consumers", October 16, 1998. *See, also,* Letter from Consumers Union and Consumer Federation of America to Chairman William E. Kennard, August 13, 1998 ("...we believe that as much as $2 billion in interexchange price reductions have not been passed through to consumers and businesses in the form of rate reductions for 1998.")

It is an unceasing mantra of the major IXCs that access charges must be reduced. They assail these charges as inflated and providing a windfall to incumbent LECs. They neglect to point out the vital role that access charges have played in the preservation of universal service. As USTA explains in its proposal to preserve universal service, affordable service for customers in high cost areas is made possible by support from implicit revenue sources such as interstate access charges.[28] Because the Telecommunications Act requires that universal service support be explicit, sufficient and predictable, USTA has proposed that universal service support received from interstate access charges be recovered instead from a universal service mechanism. Despite the fact that it would be irresponsible and inconsistent with the Act to reduce interstate access charges without first implementing the universal service support mechanism, the IXCs apparently have little regard for either universal service or residential customers. As explained above, USTA's universal service plan for non-rural carriers is consistent with the market based approach and will enhance and expedite access charge reductions. The Commission should adopt USTA's proposal.

F. There is No Legal Justification for Prescription.

The Commission's statutory authority for prescribing rates is limited. Section 205 requires that prescription can only occur when existing rates are illegal. There has been no such determination by the Commission and, in fact, the Commission has found that access rates are just and reasonable. The Commission noted that under the market-based approach, it will

[28]Intra-company support for universal service also comes from intrastate access charges, intraLATA toll service charges, geographic (urban to rural) rate averaging, business to residential subsidies and charges for discretionary services.

continue to ensure that rates are just and reasonable.[29] Finally, the Commission cannot deny incumbent LECs an opportunity to recover their costs as such action would be tantamount to an unconstitutional taking of property without just compensation.

The Commission should not abandon a course which it has not yet implemented for an approach which would require more regulation than it presently employs regarding the structure and pricing of access charges. As will be discussed below, only a week after the Commission adopted the still undefined market-based approach, it drastically increased the productivity factor thereby slashing the access rates paid to incumbent LECs.

IV. THE CURRENT PRODUCTIVITY OFFSET MUST BE LOWERED.

The Economic Policy Institute, in a report on the consequences of the Commission's decision to increase the productivity factor to 6.5 prepared for the Communications Workers of America, concluded that a productivity offset of 6.5 percent will cause serious damage to the local phone industry. "The evidence clearly shows that productivity growth in this sector has not been fast enough to support this rate of price decline. This rate of price decline will not allow the industry to earn a rate of return that is remotely comparable to that available in other sectors of the economy. Unless the industry can force large reductions in wages and benefits on its workers, the inevitable consequence will be disinvestment in the telephone industry."[30]

There is no evidence or circumstance which supports an increase in the current productivity factor. In fact, the evidence since the adoption of the Price Cap Order, as will be

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[29]Access Reform Order at ¶ 264.

[30]Dean Baker, Economic Policy Institute, "The Consequences of the FCC Price Cap Decision", August 28, 1998.

explained below, supports a reduction in the productivity offset. The motivation of AT&T and MCI to seek a higher productivity offset is obvious. A higher X-factor provides greater year-over-year give backs by incumbent LECs to the IXCs regardless of the reasonableness of such give-backs. Any such suggestions to increase the productivity offset are without merit and would eviscerate the benefits of price cap regulation. Access charges recover the reasonably incurred and legitimate costs of providing access services, as well as the legitimate costs of universal service. Such charges should not be lowered arbitrarily through the imposition of a high X-factor which eliminates the financial incentives to obtain greater efficiencies inherent in price cap regulation. As explained by Dr. Taylor, the theory of price cap regulation treats the productivity offset as a fixed target, fine-tuning and frequent reviews emphasizing accounting earnings have fostered a connection between measured costs and prices which threatens the incentive structure of the plan."

A. Updating the FCC and USTA Productivity Models Demonstrates that the Current X-Factor is Too High.

In its price cap order, which was the result of a three and a half year price cap performance review, the Commission raised the productivity offset to 6.0 percent and added a .5 consumer productivity dividend. As USTA pointed out in its appeal of that decision, the Commission misapplied the data and selectively utilized data by arbitrarily excluding lower averages in order to reach a result which it had negotiated with AT&T.[31] The outcome was an X-

[31] *United States Telephone Association v. Federal Communications Commission*, No. 97-1469 (D.C.Cir. 1998). *See also*, Letter from Gerald M. Lowrie, Senior Vice President, AT&T to Reed E. Hundt, Chairman, FCC, May 3, 1997 ("[i]n the event that net switched access reductions to the interexchange industry equal at least $1.7 billion effective July 1, 1997, AT&T...will make (continued...)

factor higher than the Commission's own analysis would indicate was justified.

Attachment D contains the results of an update of the Commission's own productivity model as verified by Professor Frank Gollop. USTA's analysis focused narrowly on the replication and update of the Commission's model. No evaluation of the Commission's approach is intended and nothing in this analysis should be construed as support for the Commission's methods for measuring productivity except as will be explained below. Utilizing the model exactly as the Commission staff designed it and adding results from 1996 and 1997 formed from a framework wholly consistent with that applied to the 1985-1995 period, the X-factors for 1996 and 1997 are 2.1 percent and 4.1 percent respectively. The Commission's view that rising X-Factors from 1992 to 1995 constituted an upward trend is not substantiated.[32] The trend did not exist. It was actually based on a peak in 1995. Professor Gollop explains that comparing the trend in X-factor averages over the five periods analyzed by the Commission with the trend in the seven period averages resulting from the update reveals that both trends are negative, suggesting that a longer term downward trend was in place before the 1996-97 update. In fact, the average X-factor in all three post price cap periods, 1991 to 1997, 1992 to 1997 and 1993 to 1997 is 4.5 percent or lower. No X-factor exceeds the current factor of 6.5 percent (including the CPD).

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[31](...continued)
the following commitments").

[32]Price Cap Order at ¶ 141.

Averaging Period	USTA's Update of FCC Model Average 'X'
1991 - 1995	5.0%
1992 - 1996	4.2%
1993 - 1997	4.4%

In fact, USTA has also updated its Total Factor Productivity Review Plan (TFPRP) model with 1996 and 1997 data.[33] The update of the TFPRP, as verified by Professor Gollop, based on the most recent five year moving average, which balances recent performance with the desirability of a stable X-factor, reveals the following results:

Averaging Period	USTA Average 'X' from Productivity Gains
1991 - 1995	2.7%
1992 - 1996	3.2%
1993 - 1997	3.0%

These results provide further evidence that the X-Factor adopted by the Commission is too high. Thus, the addition of the more current evidence from both the USTA TFPRP model and USTA's replication and update of the Commission's X-factor model strongly support the conclusion that the current 6.5 percent X-factor is too high. Both sets of productivity evidence demonstrate that the Commission's 1997 view of the "upper range of reasonableness" and interpretation of "a strong upward trend in productivity growth from 1992 to 1995" did not

[33]USTA's TFPRP model measures the growth in the demand actually experienced (output) minus the growth in resources actually used (inputs). The USTA TFPRP is unchanged from its previous form so that it conforms to Commission standards and relies on data which are publicly available and verifiable, unlike the models utilized by AT&T and MCI.

materialize.[34] These newer results of actual productivity gains are a strong basis for the Commission to lower the X-factor.

B. An 'Interstate Only' Productivity is Economically Meaningless and Must Not Be Adopted.

Nothing has changed which would impact the Commission's decision to reject the interstate only X-factor. AT&T and MCI have asked the Commission on reconsideration to ignore economic principles and to force access charges down faster by calculating an interstate-only productivity factor. As USTA has pointed out, there is no economically valid procedure for measuring interstate TFP. The existence of joint and common costs means that interstate TFP cannot be measured or defined or in any way attributed to interstate only. The Commission correctly concluded that there is no way to quantify the extent, if any, to which interstate productivity growth may differ significantly from total company productivity growth because no party "provide[d] a factual or theoretical explanation" to support claims that there are differences between interstate and intrastate productivity growth.[35]

AT&T's assumption that inputs grow at the same rates for interstate access services as they do for other regulated (local and intrastate) services has never been supported. As Dr. Laurits Christensen analogized, if AT&T's assumption is applied to a factory which uses the same production process to produce red and blue paper clips, the economically meaningless conclusion would be that the productivity growth of one color paper clip was different from the

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[34]Price Cap Order at ¶ 141.

[35]Price Cap Order at ¶ 110.

productivity growth of the other color paper clip.[36] Of course, such a conclusion is ridiculous. In fact, AT&T's own data suggest that if it were possible to separate interstate inputs in an economically meaningful way, which it is not, more highly capitalized inputs would produce a lower level of productivity growth. Professor Gollop concluded that one cannot examine the cost (productivity) conditions of each output in isolation because the multiple outputs are not produced in isolation.[37]

These points were underscored by NERA in CC Docket No. 94-1. "The known presence of economies of scope among interstate and intrastate services means that the cost function cannot be separable, and TFP growth cannot be measured independently for interstate and intrastate services...Interstate and intrastate services are produced using the same facilities and inputs. An increase in demand for interstate carrier access leads to precisely the same changes in investment and expenses as an increase in the demand for intrastate carrier access or, indeed, for local usage. In these circumstances, it is impossible to distinguish between productivity growth rates of intrastate and interstate services...Note that this result holds irrespective of the output growth rates of the two services."[38] NERA also pointed out that productivity growth measures

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[36]Christensen Associates, "Critique of the AT&T Performance Based Model" at 4, USTA Comments filed January 29, 1997 at Attachment 6. *See also*, Christensen Associates, "The TFPRP Provides the Best Basis for Determining the Rate of LEC TFP Growth", USTA Reply Comments, CC Docket No. 96-262, filed February 14, 1997 at Attachment 12.

[37]Professor Frank Gollop, "An Economic Analysis of the AT&T and Ad Hoc Comments" at 21, BellSouth Reply Comments, CC Docket No. 94-1, filed March 1, 1996 at Attachment. *See also*, Fuss Declaration at 3, Bell Atlantic and NYNEX Joint Reply Comments, CC Docket No. 94-1, filed March 1, 1996.

[38]William E. Taylor and Charles Zarkadas, National Economic Research Associates,

(continued...)

which are based on separated costs would be distorted by changes in the separations formulas and factors and would provide no meaningful information about productivity growth. The separations rules are arbitrary regulatory boundaries that have no economic meaning or basis for determining the input or output components of production. The inputs of telecommunications firms are not deployed by jurisdiction. Any claims made about interstate productivity resulting from intrastate productivity are based on arbitrary assumptions about inputs. The Commission was correct not to include an adjustment for interstate only productivity.

C. Reinitialization of Price Cap Indices is Unjustified.

In order to reach its negotiated reduction, the Commission unjustifiably determined that incumbent LECs should reinitialize their price cap indices for 1997 as if the 6.5 X-Factor had been in effect since 1996, thereby squeezing two years' worth of X-Factor reductions into one year's tariff. This requirement represented the equivalent of a 7.7 percent productivity factor for rates in effect on July 1, 1997. Even the Commission's gerrymandered model could not justify such a result. AT&T and others have argued that the Commission did not go far enough and suggested that the incumbent LECs adjust their indices back to 1995. The productivity offset, while based on historical models, is a prospective productivity target. There is no support in the record which indicates that previous productivity estimates were too low or that the 6.5 X-Factor would have been appropriate in earlier years. The methodology utilized by the Commission in its 1997 price cap order did not invalidate previous calculations. Constantly moving the

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[38](...continued)
Once., "Economic Evaluation of Selected Issues from the Fourth Further Notice of Proposed Rulemaking in the LEC Price Cap Performance Review", at 17, USTA Comments, CC Docket No. 94-1, January 16, 1996 at Attachment C.

productivity target will not enhance the incentives of price cap regulation.

D. Opportunities for Productivity Growth Will be Reduced in the Future.

As the Commission indicated, the effects of competition and access rate restructuring are not reflected in the historical productivity models discussed above. The restructure of access rates from per-minute to per-line rates will decrease productivity growth.[39] Dr. Christensen estimated that flat rate recovery of CCL and TIC would reduce measured TFP by approximately 0.4 percent per year and interstate revenue growth by approximately 1.4 percent per year.[40]

In addition, the failure of the major IXCs to pass through reduced per-minute charges means that demand increases as a result of the restructure will not occur. In fact, demand stimulation in the future will be a much different issue than demand stimulation in the past. Fighting for retention of market share with facilities-based competitors is very different from the previous environment where AT&T was required to reduce long distance prices when access prices declined. The downward pressure on productivity growth as a result of the growth in competition will reduce opportunities to achieve higher productivity offsets. Competition from CLECs will reduce the growth in interstate access minutes and revenues, raise marketing costs and lower productivity. Competitive losses will affect output growth before services are removed from price caps. As estimated by Dr. Christensen, a 10 percent loss in output over five years reduces revenue growth by an average of two percent per year. This reduces TFP by

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[39]Access Reform Order at ¶ 128.

[40]Indeed, even CARE acknowledges that movement from per minute charges to per line charges will lower the X-Factor by a significant amount. *See*, CARE Coalition Ex Parte Letter to Kathryn Brown, August 11, 1998 at 3.

between 0.6 percent and 1.0 percent per year. A 20 percent loss in output over five years reduces TFP growth by 1.2 percent to 2 percent per year. In a competitive marketplace, a high X-factor is unnecessary and inappropriate. The competitors of incumbent LECs are not burdened by an excessively high X-factor.

The productivity factors from 1991 through 1998 have required the ILECs to be about 48 percent more efficient in order for regulated interstate earnings to be higher in 1998 than in 1991.[41] This mandated rate of cost containment and efficiency improvements reflected by the productivity factor has directly benefitted access customers through lower prices. The 48 percent increase is above and beyond the increases in productivity necessary to keep pace with the economy-wide productivity performance of competitive firms in the U.S. Incumbent LECs under price cap regulation have been forced to undertake dramatic operational restructuring in order to achieve the modest earnings improvements through 1998. For example, these ILECs have reduced their workforce by 23 percent from 1991 through the end of 1997. Such stringent efficiency initiatives were required to exceed the cumulative 48 percent price cap efficiency requirement. Such initiatives will not be available in the future. Increased capital investment and decreased marginal returns will make it more difficult to continue to achieve productivity improvements at higher and higher levels year after year. As the Commission has explained, each time it requires carriers to adjust future rates based on retrospective changes to the productivity offset, it risks diminishing incumbent LEC confidence in the price cap system, thereby reducing the incentives to improve productivity and to undertake the risks of investing in

[41]Cumulative compounded efficiency requirements based on years at productivity factors of 4 percent, 5.3 percent and 6.5 percent through July 1998.

innovative new technologies and services. If incumbent LECs are forced to view the productivity factor as a bar that is raised every time they achieve productivity gains in excess of the bar, the basic premise of incentive-based regulation is negated.

E. The Consumer Productivity Dividend Has Outlived its Purpose and Must Be Eliminated.

The consumer productivity dividend (CPD) has outlived its purpose, is not supported by any empirical evidence and must therefore be eliminated. The Commission has acknowledged that the CPD was designed to account for anticipated gains in productivity resulting from the original transition from rate-of-return regulation. It has been over eight years since price cap regulation was initiated. Even assuming that the CPD was legitimately instituted in 1990, neither logic nor evidence supports its use in 1998 and beyond. Surely any transitional productivity gains have been realized. Given the lack of empirical support for the CPD, it now serves to force added reductions which are beyond the Commission's own excessive projections for achievable LEC productivity. The CPD must be eliminated.[42]

V. THE ADOPTION OF A STRUCTURE TO REDUCE AND ULTIMATELY ELIMINATE REGULATION OF INTERSTATE ACCESS PRICES WHEN COMPETITION IS PRESENT IS LONG OVERDUE.

As the Commission concluded in the access reform order, pricing flexibility is an integral part of the market based approach to rate regulation. "Economic logic holds that giving incumbent [LECs] increased pricing flexibility will permit them to respond to competitive entry, which will allow prices to move in a way that they would not have moved were the pricing

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[42]In the alternative, the Commission could transition the CPD by reducing it to .25 in 1999 and eliminating it in 2000.

restrictions maintained. This can lead to better operating markets and produce more efficient outcomes."[43] Under a market-based approach, the Commission must provide incumbent LECs the ability to adjust prices to meet market conditions. It is time for the Commission to move ahead and implement such a mechanism.

The economic rationale for reducing and ultimately eliminating regulation when competition is present has been articulated in the record in all of the proceedings listed above. For example, Schmalensee and Taylor recommended that the principal goal of the Commission should be to reduce, to the greatest extent possible, unnecessary asymmetric obligations on the incumbent provider. Pursuing such a policy ensures that a provider's efficiencies and relative abilities to supply customer demands determine success in the market--not regulatory distortions. More important, Schmalensee and Taylor point out that this should occur when the market is *first* opened to competitors so that entrants and incumbents will make efficient entry and exit decisions, some of which entail large investments and sunk costs. "In order for competitors to be given accurate and efficient price signals, they must compete with firms on as a symmetric basis as possible. Otherwise, market signals lead to uneconomic by pass and a wasteful duplication of society's scarce resources".[44]

In his book, Dr. Kahn also points out that the regulator must avoid the temptation to produce some competitors, even less efficient ones, by extending special preferences to them or by restraining effective competitive responses by the incumbents. He states that "asymmetrical

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[43]Access Reform Order at ¶ 270.

[44]Schmalensee and Taylor, January 29, 1997 at Attachment 1 and February 14, 1997 at Attachment 3.

restraints upon the competitive initiatives and responses of the incumbent companies...go beyond the mere preservation of competition in the direction of protecting *competitors from* competition--effectively imposing regimes of cartelization on potentially competitive markets."[45]

The record is also clear that the Commission's proposal as set forth in the *Notice of Proposed Rulemaking* in CC Docket No. 96-262 is inadequate. "The competitive triggers have little to do with competition and everything to do with enforcing the agency's agenda for the pricing for resale and unbundled network elements...The competitive triggers prolong and increase regulatory intervention in the telecommunications marketplace. Those regulatory controls are not in the public interest because they would delay the benefits of competition and could derail the competitive process."[46] Sidak and Spulber point out that "[f]acilities-based competition is already in full swing across the nation... UNE-based competition is underway as interconnection agreements that are being negotiated and completed lay the groundwork [for the] entry and expansion of competitors...entrants such as AT&T, MCI, Sprint, WorldCom, Time Warner and other competitive entrants are not 'infants', but large, well-established and experienced competitions."[47] Simply put, the Commission's proposal does not reflect current market conditions and presumes that current regulation is appropriate. As Commissioner Furtchgott-Roth recently stated, "[w]e must develop a more forward-looking blueprint to guide the transition from regulation to competition. As I have stated previously, regulation is merely

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[45]Kahn at 39.

[46]Sidak and Spulber, January 29, 1997 at Attachment 3.

[47]Sidak and Spulber at 33.

designed, to the extent possible, to replicate a competitive marketplace, but any form of regulation is an imperfect surrogate for full-fledged competition."[48] Virtually every state has adopted pricing flexibility, such as contract-based pricing for incumbent LECs without the showing suggested by the Commission.[49]

In their primer on pricing flexibility, Schmalensee and Taylor strongly recommended that even though there is no economic "bright line" for moving between phases of flexibility, objective criteria must be established so that regulation decreases as competition increases. "Generally, telecommunications markets are neither perfectly competitive nor perfectly regulated, and the correct question is therefore not whether a given firm can exercise excessive control over price in a given market but whether the benefits of a proposed regulatory modification will outweigh costs in the 'imperfect' markets in which telecommunications services are sold and regulated."[50] They explain that triggers that are used to remove successive regulatory restrictions must be known, measurable and observable to decrease the likelihood that unneeded asymmetric regulations and regulatory proceedings will distort the competitive process. "Triggers can be thought of as market symptoms which, combined with the availability of UNEs, makes actual competition more viable and potential competition a greater check on the

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[48]Commissioner Harold Furchtgott-Roth, Dissenting Statement, CC Docket No. 98-166.

[49]*See*, for example, Ex Parte Letter from William W. Jordan, BellSouth, CC Docket No. 96-262, August 14, 1998; Ex Parte Letter from Suzanne Guyer, Bell Atlantic, CC Docket No. 96-262, August 31, 1998; Ex Parte Letter from Jay Bennet, SBC, CC Docket Nos. 96-262, 94-1, September 3, 1998; and, Ex Parte Letter from Anthony Alessi, Ameritech, CC Docket No. 96-262, September 14, 1998.

[50]Schmalensee and Taylor, A Primer, at 29.

ability of the ILEC to raise prices above the competitive level. Triggers are a means for regulators to ease regulatory constraints in particular markets certain market areas for certain services and customers...In this sense, triggers work to ensure that once market conditions change, appropriate regulatory constraints immediately follow. Their use ensures that there is a timely process in place that responds to the rapidly-changing market conditions in carrier access and increases the likelihood that efficient regulatory decisions are implemented."[51] They agree with the Commission that the appropriate measure of size for network-based telecommunications markets is generally capacity tempered by addressability.[52] "That is, if rivals have capacity available that can 'address' a significant number of customers and that can be brought on line at low additional cost, the ILEC cannot exercise market power, and therefore, regulatory constraints should adjust accordingly."[53]

In addition, they assert that the Commission should analyze the extent of legal and regulatory barriers to entry and characterize the degree to which entry (or exit) would entail commitment of sunk costs for potential entrants. If entry has taken place at all, entry barriers could not be insurmountable. "[T]he availability of interconnection agreements, UNEs at cost-based prices, and resale have reduced the level of sunk costs required to enter the local exchange and carrier access markets, and prospective regulatory policy must take into account this

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[51] *Id.* at 32.

[52] Motion of AT&T Corp. To be Reclassified as a Non-Dominant Carrier, 11 FCC Rcd 3271 (1995).

[53] Schmalensee and Taylor at 31.

reduction in entry barriers..."[54] Competitors no longer have to build-out new networks to provide service.

Schmalensee and Taylor also pointed out that regulatory relief, such as volume and term discounts, contract tariffs and forbearance, should be linked to the objective triggers that measure the availability and use of competitive alternatives to incumbent LEC carrier access. They concluded that delay is costly and that any potential costs of permitting pricing flexibility even prematurely will be swamped by the benefits of competition under symmetric regulation and the costs of inefficient entry from opening markets under asymmetric regulation.

The economic analysis prepared by Schmalensee and Taylor is consistent with the recent statement of Commissioner Powell,

> Getting to competition, then, is not a construction project, as some in policy-making believe, and we are not its master-builders. Instead I view the drill as handing off decision-making responsibilities to the market. Our work leading up to the change of command is to prepare our institutions for that change, and forbearance is one of the key levers we pull to execute the trade. Government does have a key role to play in ensuring that the conditions that are necessary for the market engine to work properly are in place, yet it must be careful not to extend this concept too far. Before imposing too many regulatory conditions or adding incentives to fuel competition, we should first diagnose the market to see if it is functioning well without government intervention. Is there a monopolist in the market? Is there evidence that prices are being held to competitive levels? Can consumers find substitutes for services? Is there evidence of produce and service innovation? Do we see new entrants coming into the market? Do we see growth in the market? If the answer to most of these questions is yes, government should resist the temptation to tinker by offering additional kindling to the fire or imposing additional discipline in the form of new rules or restrictions. That tends to distort the market dynamic.[55]

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[54] *Id.*

[55] Commission Michael Powell, Personal Communications Industry Association, Orlando, (continued...)

In the attached paper, Dr. Taylor provides several simple principles that the Commission should follow: first, market forces are vastly superior than reliance on regulation to determine efficient levels of output, investment and price and the Commission should rely primarily on them; second, it is essential to reduce unnecessary asymmetric obligations when the market is *first* fully opened to competitors; third, the Commission should pursue a policy that rewards efficiency, not one that protects particular competitors; and, fourth, rates should reflect specific costs and specific conditions in specific markets. Dr. Taylor reviews USTA's recommendation, which incorporates the components of the plans proposed by Ameritech and Bell Atlantic and concludes that USTA's recommendation is consistent with these economic principles.[56]

As depicted in Attachment E, USTA provides for the relevant interstate carrier access market to be defined based on geographic components, Metropolitan Statistical Areas or a LATA, or transport or switched access service components with the latter further defined as residence and single line business or multi-line business.[57] This reflects the fact, as discussed above, that the characteristics of access markets vary, with the pace of competition developing differently by geography and type of service. Initially, data indicate that competitors have targeted the lucrative high capacity special access markets, switched transport markets and multi-line business customers.

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[55](...continued)
Florida, September 23, 1998.

[56]USTA's plan has been modified since it was first introduced in CC Docket No. 96-262 to reflect the individual plans submitted by its price cap member companies.

[57]An MSA is an urban area and its surrounding communities that meet specified population criteria and have strong economic and social ties.

In the preliminary or first phase of transitioning from regulation to competition, the competitive trigger for transport services should be a state-approved interconnection agreement or SGAT and that customers are utilizing alternative transport services. For switched access, the competitive trigger would be a state-approved interconnection agreement or SGAT and customers are utilizing alternative switched access services. These triggers recognize that barriers to entry have been eliminated and customers have exercised their option to switch from the incumbent provider to another competitor. They ensure that the requirements of Sections 251 and 252 of the Act are met and competitors have the tools, including interconnection, access to UNEs, resale, collocation and reciprocal compensation, to "win" a customer and reduces the costs of entering the market.

In the area or for the specific services in the market which meet the competitive triggers in Phase I, the following regulatory relief should be granted: no public interest petition or cost showing requirements for new services, elimination of Part 69 codification, price deaveraging, expanded volume and term pricing, contract tariffs and the ability to offer promotional pricing.

The relief in Phase I is directed toward eliminating the asymmetric regulation which the economists warn pose greater risks for consumers through inefficient entry and pricing. Relief from regulation of new services is long overdue as the Commission should remove any rule which in any way hinders the introduction of a new service or delays the deployment of new technologies. The current rules, which require an incumbent LEC to seek a waiver of the rules in order to introduce a service which is not included in the list of codified access charge elements and subelements adds unnecessary costs and delay to the introduction of new services and places incumbent LECs at a severe competitive disadvantage. The averaging of costs and prices

permits competitive undercutting in low-cost markets while incumbents are still required to serve high cost markets at non-compensatory rates. The ability to deaverage will help to alleviate the asymmetrical restraints on the competitive responses available to incumbent LECs and allow incumbent LECs to more closely align rates with the way costs are incurred. Volume and term discounts are useful strategies in competitive markets that provide substantial benefits to customers and prevent inefficient investment in the network by more closely aligning customer preferences with costs. The ability to offer contract-based tariffs and promotional pricing provides more choices for customers. Since all of these are already available to the competitors of incumbent LECs, the Commission should stop protecting competitors from competition and provide the same opportunities to incumbent LECs.

In the second phase of the transition, the competitive trigger for transport service would be a showing that 25 percent of an incumbent LEC's transport demand is addressable through collocation arrangements or alternative networks, and customers are utilizing alternative transport services. For switched access services, the competitive trigger would be a demonstration that 25 percent of an incumbent LEC's local exchange service demand (total or by customer) is addressable through UNEs sold to competitors or through alternative facilities and customers are utilizing alternative switched access services. The Phase 2 triggers demonstrate that competitors have sufficient opportunities with enough capacity to serve a significant portion of the market's customer demand. Upon such showings, incumbent LECs would be permitted to simplify the price cap basket structure as described in Attachment G and the services which meet

the trigger will be subject to a reduced productivity factor.[58] Such relief from price cap regulation as competition increases reflects the impact of competition on the ability to achieve the same productivity levels discussed previously and is consistent with the experience of AT&T in its transition from regulation to non-dominant status. It is more difficult to "harvest" productivity gains after years under price caps.

Finally, in the final phase of transitioning to competition, when competitors are capable of serving at least 75 percent of the market as defined in Phase 2 and customers are utilizing these alternative access services, the services would be removed from price cap regulation. In this phase, market forces are sufficient to protect customer interests.

VI. CONCLUSION.

USTA's transition plan for streamlining regulatory constraints is an economically sound framework which allows market forces to reform the markets for access services. Further delay in the adoption of this transition plan raises serious economic concerns. The Commission must resist the self-serving chorus of AT&T and MCI and others seeking a prescriptive reduction of

[58]USTA's proposed basket structure provides no increased revenue and does not provide any unauthorized ability to shift revenues between access categories. However, in order to align access prices with UNE prices, incumbent LECs need limited flexibility to shift revenues between access categories.

access rates and implement the market-based approach as described above. The only other action which the updated record supports is a reduction in the X-factor and the adoption of USTA's universal service proposal for non-rural carriers.

Respectfully submitted,

UNITED STATES TELEPHONE ASSOCIATION

By: Linda L Kent

Its Attorneys

Lawrence E. Sarjeant
Linda L. Kent
Keith Townsend
John W. Hunter

1401 H Street, NW, Suite 600
Washington, D.C. 20005
(202) 326-7248

October 26, 1998

CERTIFICATE OF SERVICE

I, Donna Young, do certify that on October 26, 1998, copies of the accompanying Comments of the United States Telephone Association were either hand-delivered, or deposited in the U.S. Mail, first-class, postage prepaid to the persons on the attached service list.

Donna Young

Ward W. Wueste
GTE Service Corp.
1850 M St., NW
Suite 1200
Washington, DC 20036

Robert L. Goggarth
Personal Comm. Industry Assn.
500 Montgomery St.
Suite 700
Alexandria, VA 23314-1561

Christopher W. Savage
Centennial Cellular Corp.
COLE, RAYWID & BRAVERMAN, L.L.P.
1919 Pennsylvania Ave., NW
Suite 200
Washington, DC 20006

Alliance for Public Technology
901 15th St., NW
Washington, DC 20005

Benjamin H. Dickens, Jr.
The Western Alliance
Blooston, Mordkofsky, Jackson & Dickens
2120 L St., NW
Washington, DC 20037

David J. Newburger
American Assn. for Adult & Continuing Educations...
One Metropolitan Square
Suite 2400
St. Louis, MO 63102

John J. List
Rural Telephone Finance Cooperative
2201 Cooperative Way
Herndon, VA 20171

Joe D. Edge
Puerto Rico Telephone Co.
Drinker Biddle & Reath
901 15th St., NW
Suite 900
Washington, DC 20005

James A. Burg
South Dakota PUC
State Capitol
Pierre, SD 57501-5070

Stephen G. Kraskin
Illuminet
Kraskin & Lesse
2120 L St., NW
Suite 520
Washington, DC 20037

Northern Arkansas Telephone Co., Inc
301 E. Main St.
Flippin, AR 72634

Carol C. Henderson
American Library Assn.
1301 Pennsylvania, NW
Suite 403
Washington, DC 20004

Information Industry Assn.
1625 Massachusetts Ave., NW
Suite 700
Washington, DC 20036

Fred Seigneur
SONETECH, Inc.
109 Kale Ave.
Sterling, VA 20164

Curtis T. White
Allied Communications Group, Inc.
4201 Connecticut Ave., NW
Washington, DC 20008

Brian R. Moir
International Communications Assn.
Moir & Hardman
2000 L St., NW
Suite 512
Washington, DC 20036-4907

Laurie Pappas
Texas PUC
P.O. Box 12397
Austin, TX 78711-2397

Teresa Marrero
Teleport Communications Group Inc.
Two Teleport Drive
Staten Island, NY 10311

Margot Humphrey
TDS Telecomm. Corp.
KOTEEN & NAFTALIN, L.L.P.
1150 Connecticut Ave., NW
Suite 1000
Washington, DC 20036

Glenn B. Manishin
SpectraNet International, Inc.
Blumemfeld & Cohen - Technology Law Group
1615 M St., NW
Suite 700
Washington, DC 20036

David A. Irwin
ITCs
1730 Rhode Island Ave., NW
Suite 200
Washington, DC 20036

George Petrutsas
Roseville Telephone Co.
Fletcher, Heald & Hildreth, P.L.C.
11th Floor, 1300 N. 17th St.
Rosslyn, VA 22209

Thomas K. Crowe
Northern Mariana Island
2300 M St., NW
Suite 800
Washington, DC 20037

Mary Newmeyer
Alabama PSC
P.O. Box 991
Montgomery, AL 36101

Richard J. Johnson
Minnesota Independent Coalition
4800 Norwest Center
90 South 7th St.
Minneapolis, MN 55402-4129

Jeffrey F. Beck
Evans Telephone Co. & Others
Beck & Ackerman
Four Embarcadero Center
Suite 760
San Francisco, CA 94111

Anne MacClintock
SNET
227 Church St.
New Haven, CT 06510

Carolyn C. Hill
ALLTEL Telephone Services Corp.
655 15th St., NW
Suite 220
Washington, DC 20005

Kent Larsen
Cathey, Hutton & Assn.
2711 LBJ Freeway
Suite 560
Dallas, TX 75234

Diana Smith
The Independent Telephone & Telecomm. Alliance
ALLTEL Corp. Services, Inc.
655 15th Street, NW
Suite 220
Washington, DC 20005

Dana Frix
ACC Long Distance Corp.
Swidler & Berlin, Chartered
3000 K St., NW
Washington, DC 20007

Kathleen Q. Abernathy
AirTouch Comm., Inc.
1818 N St., NW
Washington, DC 20036

Gary L. Mann
IXC Long Distance, Inc.
98 San Jacinto
Suite 700
Austin, TX 78701

Ronald L. Plesser
Commercial Internet Exchange Assn.
Piper & Marbury L.L.P.
1200 19th St., NW
Suite 700
Washington, DC 20036

Margot S. Humphrey
The Rural Telephone Coalition
NRTA
1150 Connecticut Ave., NW
Suite 1000
Washington, DC 20036

David Cosson
The Rural Telephone Coalition
NTCA
2626 Pennsylvania Ave., NW
Washington, DC 20037

Lisa M. Zaina
The Rural Telephone Coalition
OPASTCO
21 Dupont Circle, NW
Suite 700
Washington, DC 20036

Robert B. McKenna
U S West, Inc.
Suite 700
1020 19th St., NW
Washington, DC 20036

Clint Frederick
Frederick & Warinner, L.L.C.
10901 West 84th Terrace
Suite 101
Lenexa, KS 66214

Christopher J. Wilson
Cincinnati Bell Telephone Co.
Frost & Jacobs LLP
2500 PNC Center
201 E. 5th St.
Cincinnati, OH 45202

Kathy L. Shobert
General Comm., Inc.
901 15th St., NW
Suite 900
Washington, DC 20005

Joanne S. Bochis
NECA, Inc.
100 south Jefferson Road
Whippany, NJ 07981

David C. Bergmann
Ohio Consumers, Counsel
77 S. High St.
15th Floor
Columbus, OH 43266-0550

Steve T. Nourse
Ohio PUC
Public Utilities Section
180 E. Broad St.
Columbus, OH 432153793

Scott L. Smith
Alaska Telephone Assn.
4341 B St.
Suite 304
Anchorage, Alaska 99503

Norman Myers
Ozarks Technical Community
College
P.O. Box 5958
Springfield, MO 65801

James Brennan
NYSERNET, Inc.
Rensselaer Technology Park
Troy, NY 12180-7698

Lawrence D. Crocker, III
District of Columbia PSC
717 14th St., NW
Washington, DC 20005

John Staurulakis, Inc.
Telecommunications Consultants
6315 Seabrook Rd..
Seabrook, MD 20706

Timothy R. Graham
WinStar Comm., Inc.
1146 19th St., NW
Washington, DC 20036

Michael J. Shortley III
Frontier
180 South Clinton Avenue
Rochester, NY 14646

F. Stephen Lamb
TCA, Inc. - Telecomm. Consultants
3617 Betty Dr.
Suite I
Colorado Springs, C) 80917

Wayne V. Black
American Petroleum Institute
Keller & Heckman LLP
1001 G St., NW
Suite 500 West
Washington, DC 20001

Russell M. Blau
Teleco Communications Group, Inc.
Swidler & Berlin, Chartered
3000 K St., NW
Suite 300
Washington, DC 20007

Richard M Tettelbaum
Citizens Utilities Co.
Suite 500
1400 16th St., NW
Washington, DC 20036

Gary M. Epstein
BellSouth Corp.
Latham & Watkins
1001 Pennsylvania Ave., NW
Suite 1300
Washington, DC 2004

M. Robert Sutherland
BellSouth Corp.
Suite 1700
1155 Peachtree St., NE
Atlanta, GA 30309-3610

Jack Krumholtz
Microsoft Corp.
Suite 600
5335 Wisconsin Ave., NW
Washington, DC 20006

Ellen G. Block
Ad Hoc Telecommunications Users Committee
1300 Connecticut Ave., NW
Suite 500
Washington, DC 20036

Lyman C. Welch
190 S. LaSalle St.
300
Chicago, Illinois 60603

Roger Hamilton
Oregon PUC
550 Capitol St. NE
Salem, OR 97310-1380

Wayne Leighton
Citizens for a Sound Economy Foundation
1250 H St., NW
Suite 700
Washington, DC 20005

Cynthia B. Miller
Florida PSC
2540 Shumard Oak Blvd.
Tallahassee, FL 32399-0850

Penny Baker
Missouri PSC
P.O. Box 360
Jefferson City, MO 65102

Donna N. Lampert
Mintz, Levin, Cohn, Ferris, Glovsky & Popec, P.C.
701 Pennsylvania Ave., NW
Suite 900
Washington, DC 2000

Michael S. Pabian
Ameritech
Rm. 4H82
2000 West Ameritech Center Dr.
Hoffman Estates, IL 60196-1025

Robert M. McDowell
Helein & Associates, P.C.
8180 Greensboro Drive
Suite 700
McLean, VA 22102

Danny E. Adams
Kelley Drye & Warren LLP
Cable & Wireless, Inc.
1200 19th St., NW
Suite 500
Washington, DC 20036

Rachel J. Rothstein
Cable & Wireless, Inc.
8219 Leesburg Pike
Vienna, VA 22182

Peter Arth, Jr.
State of California & PUC
505 Van Ness Ave.
San Francisco, CA 94102

Alan J. Gardner
California Cable Television Assn.
4341 Piedmont Ave.
Oakland, CA 94611

Genevieve Morelli
Competitive Telecommunications Assn.
1900 M St., NW
Suite 800
Washington, DC 20036

Randolph J. May
Compuserve Incorp. & Prodigy Services Corp.
Sutherland, Asbill & Brennan
1275 Pennsylvania Ave., NW
Washington, DC 20004-2404

James Love
Consumer Project on Technology
P.O. Box 19367
Washington, DC 20036

Thomas K. Crowe
Excel Telecommunications, Inc.
2300 M St., NW
Suite 800
Washington, DC 20037

Kenneth T. Burchett
GVNW Inc./Management
7125 S.W. Hampton
Portland, OR 97223

Emily C. Hewitt
General Services Administration
18th & F St., NW
Room 4002
Washington, DC 20405

Robert N. Kittel
U.S. Department of Defense
U.S. Army Litigation Center
901 N. Stuart St.
Suite 713
Arlington, VA 22202-1837

Albert H. Kramer
Dickstein Shapiro Morin & Oshinsky
2101 L St., NW
Washington, DC 20037-1526

Michael T. Skrivan
Harris, Skrivan & Assn., LLC
8801 South Yale
Suite 220
Tulsa, OK 74137

Edwin N. Lavergne
Ginsburg, Feldman & Bress, Chartered
1250 Connecticut Ave., NW
Washington, DC 20036

Bradley Stillman
MCI Comm. Corp.
1801 Pennsylvania Ave., NW
Washington, DC 20006

Gigi B. Sohn
Media Access Project
1707 L St., NW
Suite 400
Washington, DC 20036

Daniel J. Weitzner
Center for Democracy & Technology
1634 Eye St., NW
Suite 1100
Washington, DC 20006

Charles D. Gray
National Assn. of Regulatory Utility Commissioners
1201 Constitution Ave., Suite 1102
P.O. Box 684
Washington, DC 20044

Daniel L. Brenner
National Cable Television Assn., Inc.
1724 Massachusetts Ave., NW
Washington, DC 20036

Joanne S. Bochis
National Exchange Carrier Assn., Inc.
100 South Jefferson Rd..
Whippany, NJ 07981

David S.J. Brown
Newspaper Assn. of America
529 14th St., NW
Suite 440
Washington, DC 20045

Jack D. Kelley
KLP, Inc. d/b/a Call-America
1201 South Alma School Road - Suite 2000
Mesa, AZ 85210

Toby-Lynn Voss
Yavapai Telephone Exchange, Inc.
2001 West Camelback Road
Suite 450
Phoenix, AZ 85015

Scott J. Rubin, Esq.
Pennsylvania Internet Service Providers
3 Lost Creek Dr.
Selinsgrove, PA 17870-9357

Robert M. Lynch
Durward D. Dupre
Southwestern Bell Telephone Co.
One Bell Center-Room 3520
St. Louis, MO 63101

Michael J. Zpevak
Thomas A. Pajda
Southwestern Bell Telephone Co.
One Bell Center-Room 3520
St. Louis, MO 63101

Leon M. Kestenbaum
Sprint Corp.
1850 M St., NW
11th Floor
Washington, DC 20036

F. Stephen Lamb
TCA, Inc.
3617 Betty Dr.
Suite I
Colorado Springs, CO 80917

Charles C. Hunter
Catherine M. Hannan
Hunter Communications Law Group
1620 I St., NW
Suite 701
Washington, DC 20006

Christopher Klein
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, TN 37243

Pat Wood, III
Public Utility Commission of Texas
P.O. Box 13326
Austin, TX 78711

Steve McLellan
Washington Utilities & Transportation Commission
1300 S. Evergreen Park Dr. SW
P.O. Box 47250
Olympia, WA 98504-7250

Myra L. Karegianes
Illinois Commerce Commission
160 N. LaSalle St.
Suite C-800
Chicago, IL 60601

Jon Radoff
1630 Worcester Road
#421
Framingham, MA 01761

Colleen Boothby
Levine, Blaszak, Block & Boothby
1300 Connecticut Ave., NW
Washington, DC 20036

Richard J. Metzger
Assn. for Local Telecomm. Services(ALTS)
888-17th Street, NW
Suite 900
Washington, DC 20006

Brian Conboy
Willkie Farr & Gallagher
Three Lafayette Centre
1155 21st St., NW
Washington, DC 20036

Randall B. Lowe
Tele-Communications, Inc.
Piper & Marbury L.L.P.
1200 19th St., NW
Washington, DC 20036

Maureen O. Helmer
New York State DPS
Three Empire State Plaza
Albany, NY 12223-1350

Mark C. Rosenblum
AT&T Corp.
Room 324G1
295 North Maple Ave.
Basking Ridge, NJ 07920

Edward Shakin
Bell Atlantic
1320 N. Court House Rd..
Eighth Floor
Arlington, VA 22201

Joseph Di Bella
NYNEX Telephone Co.
1300 I St., NW
Suite 400 West
Washington, DC 20005

Margaret E. Garber
Pacific Telesis Group
1275 Pennsylvania Ave., NW
Washington, DC 20004

Nancy C. Woolf
Pacific Bell and Nevada Bell
140 New Montgomery Street
Room 1523
San Francisco, CA 94105

Martha S. Hogerty
The Group of State Consumer Advocates
P.O. Box 7800
Jefferson City, MO 65102

Ronald J. Binz
Competition Policy Institute
1156 15th St., NW
Suite 310
Washington, DC 20005

Henry D. Levine
The Bankers Clearing house
Levine, Blaszak, Block & Boothby
1300 Connecticut Ave., NW
Suite 500
Washington, DC 20036

John Rother
American Assn. of Retired Persons & Others
601 E. St., NW
Washington, DC 20049

Mark N. Cooper
Consumer Federation America
1424 16th St., NW
Suite 604
Washington, DC 20036

Robert A. Mazer
Albert Shuldiner
Vinson & Elkins
1455 Pennsylvania Ave., NW
Washington, DC 20004-1008

Riley M. Murphy
Charles H. N. Kallenbach
American Communications Services, Inc.
131 National Business Parkway
Suite 100
Annapolis Junction, MD 20701

Paul H. Kuzia
Arch Communications Group, Inc.
1800 West Park Drive
Suite 350
Westborough, MA 01581

Kennard B. Woods
Consumers' Utility Cousel Division
Governor's Office of Consumer Affairs
2 Martin Luther King, Jr. Dr.
Plaza Level East
Suite 356
Atlanta, GA 30334-4600

Werner K. Hartenberger
J.G. Harrington
Laura H. Phillips
Dow, Lohnes & Albertson, PLLC
1200 New Hampshire Ave., NW
Suite 800
Washington, DC 20036

Terri M. Lyndall
Georgia Public Service Commission
244 Washington St., SW
Atlanta, GA 30334-5701

Herbert E. Marks
James M. Fink
Squire, Sanders & Dempsey, L.L.P.
1201 Pennsylvania Avenue, NW
P.O. Box 407
Washington, DC 20044

Joel B. Shifman, Esq.
Maine Public Utilities Commission
242 State House Station
Augusta, ME 04333-0018

Peter A. Rohrbach
David L. Sieradzki
F. William LeBeau
Hogan & Hartson L.L.P.
555 13th St., NW
Washington, DC 20004-1109

Catherine R. Sloan
Richard L. Fruchterman, III
Richard S. Whitt
Worldcom, Inc.
1120 Connecticut Avenue, NW
Washington, DC 20036

James U. Troup
Steven J. Hamrick
Arter & Hadden
1801 K Street, NW - Suite 400K
Washington, DC 20006

Wayne V. Black
C. Douglas Jarrett
Susan M. Hafeli
Keller and Heckman, LLP
1001 G Street, NW - Suite 500 West
Washington, DC 20001

Linda Nelson
Florida Department of Management Services
4050 Esplanade Way
Tallahassee, FL 32399

Judy Sello
AT&T
295 North Maple Avenue
Basking Ridge, NJ 07920

James Blaszak
Levine, Blaszak, Block & Boothby
1300 Connecticut Ave., NW
Washington, DC 20036

Jonathan Jacob Nadler
Squire, Sanders & Dempsey
1201 Pennsylvania Avenue, NW
Washington, DC 20044

Peter H. Jacoby
AT&T
295 North Maple Avenue
Room 3244J1
Basking Ridge, NJ 07920

Eugene Baldrate
Cincinnati Bell
201 E. Fourth Street
Room 102-910
Cincinnati, Ohh 45201

Robert J. Aamoth
Competitive Telecommunications
1301 K Street, NW
Suite 1100 - East Tower 5
Washington, DC 20005

ITS
1231-20th Street, NW
Washington, DC 20036