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FEDERAL COMMUNICATIONS COMMISSION
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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

REPLY COMMENTS OF GTE

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No. of Copies rec'd 0+11
List A B C D E

November 9, 1998

SUMMARY

The record in this proceeding and the passage of time have made one thing clear: a market-based approach, although unassailable in theory, cannot work unless the Commission takes steps to fully implement it. Both the marginal adjustments to the agency's existing, so-called "market-based" mechanism and the drastic prescriptive steps proposed by some in the record raise substantial legal difficulties and are bad policy. Rather, the Commission should follow GTE's proposed plan to reform access charges as outlined below.

First, the Commission should complete its current work on reforming universal service by removing implicit subsidies from access charges consistent with Section 254 of the Act and sound public policy. These subsidies should be replaced on a dollar-for-dollar basis with explicit mechanisms along the lines recently proposed by the United States Telephone Association ("USTA"), and include a framework to address subsidies presently embedded in non-common line rate elements.

Second, the Commission should permit incumbent local exchange carriers ("ILECs") to price their access services flexibly. Such flexibility would 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 also should establish an orderly process for further streamlining of the Commission's access regulation, such as contract-based pricing and streamlined 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 approach. In addition, GTE urges the FCC to eliminate the arbitrary distinction between primary and non-primary lines for purposes of assessing different access rates and for the calculation of universal service support.

Far from offering any new approaches to truly market-based reform, the interexchange carriers ("IXCs") and competitive local exchange carriers ("CLECs") seek to continue to hamstring ILEC efforts to introduce competitive measures into the access services market. While rejecting the IXCs' prescriptive measures, the CLECs generally urge the Commission to deny ILEC requests for pricing flexibility or favor only limited pricing flexibility measures. The Commission should decline to follow the CLECs' suggestions, which would only further impede competition in increasingly competitive access markets, particularly for large-volume access customers.

On the other hand, MCI, AT&T, and others seek to impose drastic prescriptive measures based upon the predictable assertion that "true competition" has not developed in the local service and access markets. These prescriptive proposals – regardless of their individual variations – would be arbitrary, contrary to the goals of the Commission's price cap framework, and would ultimately harm consumers.

- The proposal of AT&T and others to use a hypothetical cost model to prescribe rates is flawed because, among others problems, those models do not provide a reasonable basis for establishing a new level of overall cost for the ILEC industry.

- While each piece of MCI WorldCom's proposal is flawed, its plan to simultaneously prescribe access charge rates while increasing and retroactively applying the X-factor amounts to the equivalent of a regulatory "piling on" that would result in an unconstitutional taking.

- CompTel's "Prescriptive Transition Plan" fails to allow for recovery of all overhead costs and is simply another form of prescription that will stall the development of competition.

- Washington Utilities' proposal to move subsidies from terminating to originating access charges will result in unrecoverable losses to ILECs and in the Commission having to adopt an entirely new approach to regulation.

- Ad Hoc's "Make Whole or Make Money" proposal is empty rhetoric with no real options because ILECs must choose between the inherent problems with a prescriptive approach or increased regulation by the Commission.

In short, taking such action would amount to a giant step backward on the road to genuine market-based reform.

Finally, the Commission should continue to calculate TFP based on total company data and reduce the X-factor to calibrate with recent LEC performance under price caps. Recent data indicates that the Commission's 6.5% X-factor was clearly set too high. Contrary to extensive evidence, some commenters urge the Commission to adopt two measures that would serve to increase the X-factor. These efforts should be rejected. First, there is no economically defensible method for calculating the proposed interstate-only X-factor. Second, reinitialization of rates back to 1995 using either the 6.5% X-factor or a new interstate-only X-factor should be rejected as impermissibly retroactive, arbitrary, and contrary to the foundations of the price cap regime. The Commission also should stop artificially manipulating ILEC productivity data to reach the X-factor, including adding a .5% consumer productivity dividend.

In short, the goal of allowing market forces to establish access rates can be achieved only if the Commission adopts a truly market-based approach to access reform. GTE's proposal does exactly that, and therefore should be adopted in lieu of the more regulatory prescriptive measures favored by MCI and others, or the CLECs' attempts to maintain the asymmetric regulatory treatment between competitors by denying pricing flexibility to ILECs.

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REPLY COMMENTS OF GTE

GTE Service Corporation and its below-listed affiliates[1] (collectively "GTE") respectfully submit their reply comments in response to the Commission's Public Notice issued in the above-captioned proceeding.[2] In its opening Comments, GTE urged the

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[1] 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 Railfone Incorporated, GTE Communications Corporation, GTE Wireless Incorporated, GTE Media Ventures Incorporated, and GTE Internetworking Incorporated.

[2] 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). All comments cited herein were filed in response to the Public Notice, FCC 98-256 (CC Docket No. 96-262, CC Docket

Commission to remove implicit subsidies from access charge rates and adopt a true market-based approach by giving ILECs immediate pricing flexibility. As set forth below, the record underscores the importance of moving rapidly on GTE's proposal in order to further promote competitive access charge rates. In addition, the Commission should reject the IXCs' calls for a prescriptive approach and should decrease the X-factor based upon company-wide analysis.

I. INTRODUCTION

An examination of the comments filed in this "refresh the record" proceeding reveals that there is nothing new that IXCs and CLECs have filed that in any way improves upon the record to date. In fact, virtually all of their positions are identical to positions that they have previously presented to, and rejected by, the Commission. The passage of time has proven one thing, however: a market-based approach, although unassailable in theory, cannot work unless the Commission takes the steps to fully implement it. GTE urges the FCC to do so now.

GTE's plan to implement truly market-based access pricing first requires the FCC to rid access charges of implicit subsidies. These subsidies total approximately $5.9 billion – comprised roughly of $4.3 billion from common line elements and $1.6 billion from non-common line elements.[3] Access markets cannot be competitive if implicit

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(...Continued)
No. 94-1, CC Docket No. 97-250 and RM-9210) on Oct. 26, 1998, unless otherwise noted.

[3] GTE previously has estimated the implicit support flow from interstate access at $6.3 Billion. *See* Comments of GTE at 7 ("GTE Comments"). The estimate provided here is revised to reflect reductions in access rates through the annual filings of July

subsidies prevent them from competing with competitive access offerings that do not contain such subsidies. Similarly, CLECs cannot be expected to compete effectively against ILECs for services that are receiving the benefit of such subsidies.

In addition, the FCC should implement substantial pricing flexibility along the lines advocated by USTA. The FCC should particularly allow, as soon as possible, certain flexibility that would produce prices more closely aligned with costs and pricing that would benefit consumers without significant potential for competitive harm. Geographic deaveraging, volume and term discounts, and streamlined new services introduction should be allowed immediately where USTA Phase I triggers exist. Any potential for anticompetitive discrimination can be avoided through safeguards that seek to enforce existing anti-discrimination provisions of the law, rather than the current draconian policy of prohibiting such pricing flexibility altogether. Such action harms consumers by depriving them of reasonable prices and competition by sending false signals to the market. Further deregulation should occur when reasonable competitive triggers are met.

Once these reforms are instituted and allowed to operate in the market for a reasonable period of time, the FCC will discover that they indeed had it right: a market-based approach will lead to better and more pro-consumer and pro-competitive pricing and service offerings than a prescriptive approach could possibly achieve. Indeed, contrary to IXCs' claims, there is simply no basis to consider prescription on the basis that the FCC's market approach has "failed." To the contrary, in GTE's view, the

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1998.

Commission has yet to enact true market-based reforms. Moreover, a prescriptive approach is also unwise and unlawful because the methodologies proposed by IXCs and CLECs would lead to below-cost pricing and would send incorrect pricing signals to the market. Further, political fiddling with the X-factor undermines the incentives of price cap regulation and would be arbitrary and capricious. Instead, the FCC should reject the IXCs' ill-conceived demands for prescription and should move toward real, market-based reform of access pricing.

II. THE RECORD CONFIRMS THE NEED TO ADOPT GENUINE MARKET-BASED ACCESS CHARGE REFORM.

In its opening comments, GTE urged the Commission to use this opportunity to take the necessary steps to implement a truly market-based approach to access charge reform. Put simply, the Commission must provide a reasonable starting point for such an approach by: (1) completing its reform of federal universal service support mechanisms by removing all implicit subsidies from access charges and replacing them on a dollar-for-dollar basis with explicit universal service funding; and (2) allowing ILECs to price their access services flexibly. These steps – rather than onerous prescriptive measures proposed by MCI WorldCom and others – 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.

Contrary to the suggestions made in this proceeding, the Commission should not attempt to make marginal adjustments to its so-called "market-based" approach, or in any event, make prescriptive rate reductions. Some parties erroneously assume that implicit universal service support subsidies left in access charges should be "eroded" away by competition. This is the crux of the access reform debate. Universal service support subsidies should never be subjected to any kind of erosion. Rather, universal service support subsidies must be made explicit, sufficient, and predictable as required by the Act.[4] Even more troubling, those who support a prescriptive approach fail to adequately explain how these prescriptive measures would ensure that: (1) universal service funding will be sufficient as required by § 254(e) of the Act; (2) access charge rate structure would be improved; or (3) access competition would develop in such an environment.

A. Removing Remaining Implicit Universal Service Subsidies From Access Charges Is The Predicate To True Access Reform.

Unlike the IXCs who focus exclusively on access charge rate levels, the Commission is required by § 254(e) of the Act to recognize the fundamental link between implicit subsidies in access charges and explicit, competitively-neutral universal service recovery mechanisms.[5] As explained in its opening Comments, GTE estimates that the amount of implicit subsidy remaining in interstate access charges for non-rural LECs is approximately $5.9 billion.[6] These subsidy amounts represent real

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[4] 47 U.S.C. § 254.

[5] *See* Comments of AT&T Corp. at 4-7 ("AT&T Comments"); Comments of MCI WorldCom at 26 ("MCI WorldCom Comments").

[6] GTE Comments at 7-8. As noted above, this total figure is comprised of roughly $4.3 billion of implicit common line element subsidies and $1.6 Billion of implicit non-common line subsidies. GTE previously has estimated the implicit support flow from interstate access at $6.3 Billion. *See Id.* The estimate provided here is revised to reflect reductions in access rates through the annual filings of July 1998.

costs that either be "assumed away" by prescriptive reductions or "competed away" through the Commission's so-called market-based approach. The results of such policies would be to simply transfer money from ILECs to IXCs, a clear takings violation.[7] Moreover, the continued presence of these subsidy levels in access charge rates has a number of deleterious effects.

First, allowing implicit subsidies to remain in access charges is inconsistent with Section 254(d)'s requirement that every carrier contribute on "an equitable and nondiscriminatory basis, to the specific, predictable, and sufficient mechanisms" developed by the Commission to support universal service.[8] Keeping implicit subsidies in certain access services simply retains the old discriminatory system where only some interstate providers contribute to their support. Further, it encourages access customers to avoid contributing to the universal service implicit subsidies by purchasing competitive alternatives, thereby placing further contribution burdens on the ILEC and its customers. Therefore, such a scheme is inconsistent with the objective of Section 254(d).

Second, retaining existing implicit subsidies in access charges skews competition in local exchange markets. Notably, Western Wireless explains that allowing implicit universal service subsidies to remain embedded in access rates, which

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7 *See* Affidavit of J. Gregory Sidak and Daniel F. Spulber, Attachment 3 to Comments of the United States Telephone Association ("USTA"), CC Docket No. 96-262 (filed Jan. 29, 1997); Reply Affidavit of J. Gregory Sidak and Daniel F. Spulber, Attachment 2 to Reply Comments of USTA, CC Docket No. 96-262 (filed Feb. 14, 1997).

8 47 U.S.C. § 254(d).

are not made available to prospective competitors, is "a major impediment to the development of vigorous local competition, especially in rural and high-cost areas."[9] GTE maintains that correct market signals in both access and local markets may be provided by explicit, portable universal service support that would be available to new entrants.[10] Such carriers 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.

Third, implicit subsidies that result in access rates that are different from market-based pricing foster inefficiencies in the way services are allocated in the marketplace and in the way suppliers can respond to technological changes and market dynamics. Indeed, MCI WorldCom observes one manner in which the inefficiencies inherent in above-cost access rates translate to consumer harms: "[s]ince access charges are above cost, consumer long distance prices are too high."[11] MCI WorldCom further explains that above-cost access charges have "undoubtedly deterred the development and use of productivity-enhancing innovations."[12] GTE maintains that it is precisely

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9 Comments of Western Wireless Corporation at 4 ("Western Wireless Comments").

10 *Accord* Prepared Remarks of John Stanton, Chairman and CEO of Western Wireless Corporation, before the Universal Service Joint Board, at 4 (noting that "[r]egulators must ensure that universal service support is fully portable – that is, that competitive providers receive the same dollar amount of support as incumbents for each line they serve.").

11 MCI WorldCom Comments at 22.

12 *Id.*

these types of inefficiencies that can be reduced by removing implicit subsidies from access charges.[13]

Accordingly, the Commission should take prompt action to remove implicit subsidies from access charge rates, and preserve them as explicit subsidies, so that they are available to other carriers. Such action is particularly significant to GTE and other carriers of last resort who do not have the ability – as do IXCs and CLECs – to selectively serve certain customer segments in targeted geographic areas. The carrier of last resort obligations of ILECs particularly applicable to price-cap carriers, permits IXCs and CLECs to urge the adoption of prescriptive measures under the guise of competition without the concern of removing implicit subsidies from access charges. As GTE suggested in its opening Comments, adoption of USTA's recently-proposed universal service plan, where implicit subsidies generated by the presubscribed interexchange carrier charge ("PICC") and carrier common line ("CCL") would be replaced by explicit, portable support amounts, would be an important first step.[14] Further, GTE urges the Commission to develop other mechanisms to address the remaining subsidy levels that exist in non-common line rate elements. True access reform will be possible only after such steps are taken.

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13 To the extent that MCI WorldCom implies that access rate are based on inflated costs, GTE specifically denies this implication. There are no credible facts on the record to support such a conclusion.

14 GTE Comments at 7-9; *see* Letter from John Hunter to Magalie Roman Salas, CC Docket 96-45 (Sept. 24, 1998).

B. The Commission Should Not Impose New Artificial Cost Structures When Sizing The Universal Service Support Subsidy.

GTE evaluates the total interstate subsidy flow by considering the contributions generated by the rates for other ILEC services, such as access and toll service, and comparing them to the contributions those rates would generate if they were rebalanced.[15] As noted above, GTE estimates that the implicit support in interstate access charges is approximately $5.9 billion per year. Another approach to quantifying the implicit support flows in the current system would be to compare the rates for local service to the cost of providing that service. This is the basic approach the Commission has outlined in its May 1997 *Universal Service Order*.[16]

If consistent methods were used to measure costs and revenues, then these two approaches should yield similar results. That is to say, the "sources" of *supranormal* contribution in the system should just about offset the "sinks" of low (or negative) contributions for basic local service. If, however, the measure of cost that is used for universal service calculations is inconsistent with the cost level that has produced the

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[15] It should be noted that this estimate does not include transfers of support *within* switched access. For example, because the subscriber line charge is geographically averaged today, a low-cost multiline business customer in an urban area may pay $9 per month, while a high-cost residence customer may pay only $3.50. Since GTE's calculation examines the contribution from switched access on an aggregate basis, it averages these customers together.

[16] *Federal-State Joint Board on Universal Service*, 12 FCC Rcd 8776 (1997).

current rates, then the answers may differ. It is precisely this inconsistency that parties such as MCI WorldCom are asking the Commission to adopt as a matter of policy.[17]

Contrary to the suggestion of CompTel and MCI WorldCom, the forward-looking cost models – including the HCPM model "platform" recently adopted by the Commission – are not suitable for estimating the overall level of a LEC's cost.[18] As GTE explained in its opening Comments in this "refreshing" round of this proceeding, it is unreasonable to use such a model – without any other information on cost levels – to estimate universal service support.[19] It is equally unreasonable to use an estimate created by a model to prescribe a new level of access rates, without replacing the current implicit support with explicit universal service funding.

It is widely recognized that access rates were established at divestiture to replace the flow of support which had previously been generated by long distance rates through the separations and settlements processes. Even MCI WorldCom

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[17] An inconsistent answer can also be produced by leaving out some part of the system, or by making inconsistent assumptions about revenues. If, for example, contributions for services other than local service are counted in the universal service calculation, then the support absorbed on the "sinks" side of the system will be understated, because some of the "sources" will have been averaged into the calculation. Since these contributions will also be counted in the "sources" calculation, the two approaches will give inconsistent answers. This error could affect access charges if the estimate of USF derived from a cost model is used in developing access rates, as some parties have suggested. In these reply comments, GTE will focus on the issue of consistent measurement of cost.

[18] *See* Comments of the Competitive Telecommunications Association at 5-7 ("CompTel Comments"); MCI WorldCom Comments at 26.

[19] *See* GTE Comments at 15.

acknowledges that access provides a flow of support to universal service.[20] While access rates have been extensively adjusted over time, through the implementation of the Subscriber Line Charge ("SLC") and through the mechanism of the price cap plan, access continues to provide an implicit support flow to local service.

Therefore, it does not follow simply because margins in access rates are high relative to estimates of forward-looking cost, that ILEC costs are too high. Indeed, unless the Commission has reason to find that the *overall* level of ILEC costs is too high (which it does not), then the high margins in access simply offset low, or negative, margins elsewhere. Nor does the current price structure represent "monopoly" pricing by ILECs.[21] Not even a textbook monopolist, left to its own devices, would choose to set high prices for more elastic services, and low prices for its least elastic service, as ILECs are forced to do today. Instead, the current level of access charges represents the constraints on local prices elsewhere in the system, and the long-established policy of using access to recover a disproportionate amount of the ILECs' total cost.

As discussed below in Section IV, there is no basis for arbitrary reductions in the overall current level of access charges, in the absence of universal service funding. Neither the application of the forward-looking cost model, nor the record of ILEC productivity performance, would justify such a reduction. GTE's approach to measuring the implicit support in access, which takes as its starting point the ILECs' current cost level as determined by the price cap indices, is therefore reasonable.

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20 *See id.* at 26.

21 *See id.* at 9-11.

Rather, the Commission's objective must be to rebalance the sources of ILEC cost recovery, replacing the implicit support in current access rates with explicit funding from a competitively neutral funding mechanism. A forward-looking cost model could have an important role to play in this process if it is formulated correctly, since the relative levels of estimated forward-looking cost for access and local service should guide this rebalancing. GTE has used forward-looking cost estimates in this way to reach its estimate of the implicit support in interstate access. However, since many of the models under discussion do not provide reliable information concerning the overall level of ILEC costs, this process should not be used to impose a new – and entirely artificial – cost level on the industry.[22] Instead, the process should be designed to ensure that it is consistent with the current cost level; the proposals submitted by GTE, and by USTA, incorporate this principle.

C. Regulatory Barriers To Competitive Provision Of Access Services Have Been Removed.

1. Competition in access markets is not necessarily tied to local exchange competition.

A number of IXCs base the need for dramatic prescriptive measures on the predictable assertion that "true competition" has not developed in the local service and

[22] The FCC has recently adopted a cost model platform for use in determining support payments for carriers in insular, high cost, and rural areas. See Federal State Joint Board On Universal Service, FCC 98-279 (rel. Oct. 28, 1998). By mentioning this platform, GTE does not mean to imply that it endorses it. Any issue GTE has with respect to this model will be raised in that proceeding.

access markets.[23] These parties further claim that the absence of actual competitive alternatives to local and access service in a variety of market segments is proof that the market-based measures simply are not working and that the Commission must resort to prescriptive measures.[24] In addition, while some CLECs indeed oppose prescription (and others are notably silent on the issue), these carriers urge the Commission to deny ILECs pricing flexibility largely for the same reasons IXCs use to justify prescription.[25]

First, GTE disputes the premise of the IXCs' and CLECs' arguments that regulatory barriers to local competition remain. To the contrary, carriers who wish to compete in the local service market may readily avail themselves of the rights provided under Sections 251 and 252 of the Act to obtain interconnection, access to unbundled network elements, collocation, and resold services. As GTE has explained in other proceedings – and will not repeat in detail here – existing rules are working well to facilitate local competition and provide competitors with UNEs and collocation and the Eighth Circuit's decision concerning the recombination of UNEs does not pose a regulatory barrier to providers.[26] The Commission also should take into account that

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23 *See* Comments of The Association for Local Telecommunications Services at 7-10 ("ALTS Comments"); AT&T Comments at 3-8; CompTel Comments at 2-3.

24 *See, e.g.,* AT&T Comments at 3-6; MCI WorldCom Comments at 14-15.

25 *See, e.g.,* ALTS Comments at 4; Comments of MediaOne Group, Inc. at 2-4 ("MediaOne Comments"); Comments of NEXTLINK Communications, Inc. at 4. ("NEXTLINK Comments"); Comments of Time Warner Telecom Corporation at 2-4 ("Time Warner Comments").

26 *Iowa Utilities Bd. v. FCC*, 120 F.3d 753 (8th Cir. 1987) as amended on rehearing (Oct. 14 1997), *cert. granted* 66 U.S.L.W. 2459 (U.S. Jan 26, 1998) (No. 97-826). *See, e.g.*, Comments of GTE, CC Docket No. 98-147 (filed Sept. 25, 1998).

the different rate at which competition is developing in local markets probably reflects a business choice of CLECs or CAPs to serve only particular customers because regulatory fiat sends incorrect market entry signals. Thus, the regulatory framework is in place to allow local competition to develop.

Second, these arguments obfuscate the difference between the market for access services and the market for local services. The characteristics of the market for access are determined by the nature of the end-user locations where interstate long distance traffic originates or terminates. A substantial proportion of interstate long distance service demand is generated by large, sophisticated business end-user customers. A large end user of this kind has sufficient volumes of long-distance calling to justify the use of a dedicated access connection to its chosen IXC; this link may be purchased by the IXC or by the end user, and it may be provided by the ILEC or by an alternative carrier, such as a CAP. These end users are usually geographically concentrated, are sophisticated enough to be well aware of their service options, and are attractive targets for alternative providers.[27]

For large end user customers, the choice of access provider is separable from the choice of local service provider, and alternative carriers do not need to provide local dial tone service in order to provide competitive access services. Further, CAPs can reach many of these locations directly with their own networks, without relying on

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27 Alternative sources of supply are available to these large end user locations in many parts of the country. CAP fiber networks have been constructed in at least 300 cities nationwide. This includes every major metropolitan area, but it also includes areas outside of major MSAs where clusters of high-volume end users represent significant sources of demand, such as Broken Arrow, Oklahoma, and Andalusia, Alabama.

UNEs.[28] For the large business end users, serving arrangements based on dedicated access links to IXCs allow the customer to obtain switched long distance service without using the switched access service provided by ILECs.[29] Further, the end-user's ability to choose an alternative access arrangement does not depend on the availability of competitive local exchange service in the area. For these end user locations, the market for interstate access services is separate from the market for local exchange service.

The Commission also should recognize that, for large business customers, special access services provide a close substitute for ILEC switched access, since dedicated links to IXCs can be used to provide switched long distance service. Competition in the market for high capacity circuits, which is well developed in many areas, thus exerts substantial competitive pressure on ILEC switched access provided to those high volume customers, who generate a substantial proportion of the demand for switched access in these areas.

Third, the IXCs' and CLECs' arguments are grounded in an incomplete and distorted picture of both the status of competition and the effect of such competition on the relevant market for this proceeding – the access market. In reality, access competition for services ultimately provided to large business customers is booming.

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28 For example, in the Dallas-Fort Worth area, Teleport's network extends from east of Dallas to West of Forth Worth, and reaches most of the suburbs where high-tech industry is located, such as Plano and Las Colinas.

29 In such a serving arrangement, the end user customer obtains a direct connection to the IXCs' point of presence ("POP"), and routes long distance calls onto that direct connection using the private branch exchange ("PBX") or key system on the customer's premise.

As a number of commenters point out, competitive access providers ("CAPs") currently offer transport and switching services in key geographic and customer market-segments.[30] CAPs have provided direct-trunked transport in competition with ILEC transport, are competing aggressively in special access, and have established the capacity to provide switched access and local exchange service.[31] For example, even the 1995 data described in the NERA report, describes that "high capacity service losses to competitors were as high as . . . 50 percent in New York City . . . 39 percent in Los Angeles . . . 39 percent in Philadelphia [and] 37 percent in Boston."[32] Further, by March 1995, "CLECs and CAPs had captured 10-15 percent of the nationwide carrier access market and forced LECs to reduce rates on comparable services by 20 to 30 percent per year between 1991 and 1994."[33]

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[30] *See, e.g.*, Comments of Bell Atlantic at 7-11 ("Bell Atlantic Comments"); CompTel Comments at 15; Comments of Southwestern Bell Telephone Company, Pacific Bell and Nevada Bell at 5-12 ("SWBT Comments").

[31] Richard Schmalensee & William Taylor, National Econ. Res. Associates, *The Need for Carrier Access Pricing Flexibility in Light of Recent Marketplace Developments*, Attached to *Ex Parte* Notice of the United States Telephone Association, CC Docket 96-262 at 17-18 (filed Jan. 16, 1998)("NERA Report"). Indeed, as far back as 1993, the Commission itself recognized that competition is developing the transport market by granting some level of pricing flexibility in this market in the form of zone-based pricing and other pricing plans. *See, e.g., Expanded Interconnection with Local Telephone Company Facilities Amendment of Part 36 of the Commission's Rules and Establishment of a Joint Board*, 8 FCC Rcd 7374 (1993).

[32] NERA Report at 20.

[33] *Id.* at 20-21 (citing Bernstein Research, *Telecommunications: Convergence and Divergence*, March 1995).

GTE is far from immune to competition in the access market. For example, as of June 1997, it had "lost 19,250 equivalent DS1 circuits to CAPs in its major markets."[34] In addition, it is facing substantial competition from CAPs and CLECs in most of its major markets, including Dallas, Honolulu, Los Angeles, and Tampa. Much of the HICAP loss in GTE's metro areas can be attributed to MFS WorldCom and TCG. These competitors will only get stronger now that they have merged with MCI and AT&T, respectively.[35]

2. Mergers between ILECs do not impede the development of access competition.

Moreover, the Commission should decline to follow the suggestion of AT&T that ILEC mergers will serve to reduce the ability of competition to develop in the access market.[36] There simply is no basis for the Commission to revisit its rejection of AT&T's claim raised anew that "[mergers] would greatly increase the efficacy of price squeezes in the long distance market by giving the merged entities control over the origination and termination of a greater number of interexchange calls."[37] The Commission already has decided that in the merger context "there is no basis for [the] underlying assumption that the proposed transfer will result in higher access charges, or in lower

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34 *Id.* at 21 (citing Quality Strategies Research (2Q 1997)).

35 In fact, the FCC approved these mergers precisely because it expected that the combined companies would be stronger exchange and exchange access competitors. *See, e.g., Teleport Communications Group, Inc. and AT&T Corp.*, FCC 98-169, at ¶¶ 33-39 (rel. Jul. 23, 1998).

36 *See* AT&T Comments at 12-14.

37 *See id.* at 12.

reductions in them than would occur without the proposed transfer."[38] In addition, there is little merit to AT&T's assertion that each merger "deprives consumers of potential competitors that could well help drive access charges in each affected market to cost."[39] This concern rings particularly hollow given that a vast number of potential competitors provide access services and that the Commission's own public interest analysis requires it to balance competitive benefits of the merger against any potential harmful competitive effects.[40]

D. The Commission Must Rationalize Rate Structures.

The record underscores GTE's concern that existing access prices should reflect differences in underlying cost structures so as to facilitate competition and send proper entry signals. As Ameritech points out, "regulatory intervention has resulted in a pattern of non-market prices: businesses, urban residences, and long distance users pay more than they would in a free market while those in rural areas, non-urban residences, and those who do not use long distance services pay less than they otherwise would."[41] The Commission must alleviate existing irrational rate structures to allow competition to develop. For example, statewide averaging of access rates allows CAPs to engage in

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[38] *See Application of Pacific Telesis Group, Transferor, and SBC Communications, Inc., Transferee*, 12 FCC Rcd 2624, 2648 (1997); *see Applications of NYNEX, Transferor and Bell Atlantic, Transferee ("Bell Atlantic/NYNEX"),* 12 FCC Rcd 19985, 20044-45.

[39] AT&T Comments at 13.

[40] *Bell Atlantic/NYNEX* 12 FCC Rcd at 19988, 20038-41.

[41] Comments of Ameritech at 14 ("Ameritech Comments").

arbitrage by selecting both the geographic and market segments they enter, thereby exploiting ILEC pricing structures that do not reflect its underlying cost structure.

Rate structures that are not permitted to address cost differences also will encourage inefficient market entry and distort end-user markets. To the degree that CAPs, CLECs, and IXCs make investment and entry decisions based upon incorrect pricing signals, consumer welfare as a whole will be decreased. For example, assuming that switching costs are lower for urban customers than they are for rural customers, state-averaged access rates provide an artificially high rate for services in urban areas that CLECs can exploit by pricing just under this "umbrella,"[42] while at the same time discouraging investment in rural areas. Such results make neither sound economic nor policy sense.

The Commission thus should not preclude ILECs from establishing access rates in a manner that reflects underlying costs. To this end, the Commission should permit rate changes of this type immediately. Pricing structures that allow ILECs to more accurately account for cost differences promotes efficient access service pricing and facilitates competition by sending correct signals to both incumbent providers and new entrants alike.

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[42] MCI WorldCom has essentially admitted that it engages in such umbrella pricing. *See generally* Reply Comments of MCI WorldCom, CC Docket 97-211 (filed January 26, 1998).

III. PRICING FLEXIBILITY IS A FUNDAMENTALLY IMPORTANT STEP IN ALLOWING MARKET FORCES TO WORK AND ADOPTING A TRULY MARKET-BASED ACCESS CHARGE REFORM FRAMEWORK.

A. Pricing Flexibility Is Necessary And Warranted To Provide ILECs The Opportunity To Compete With CAPs And CLECs For Access Services.

In its opening Comments, GTE proposed that a second step toward developing a truly market-based approach would be to permit "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."[43] To this end, GTE explained that the introduction of reasonable pricing flexibility along the lines proposed by USTA will allow access prices to more accurately reflect underlying cost differences, send correct entry signals to actual and potential competitors and allow consumers to reap the benefits of efficient, market-based pricing.[44]

The Commission should decline to follow the suggestion of a number of IXCs and CLECs, typified by the statement of AT&T, that consideration of pricing flexibility is "grossly premature" based upon their claim that "there is presently no significant competition in any of the ILECs' exchange access markets."[45] GTE maintains that these parties have it exactly backwards.

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43 GTE Comments at 20.

44 *See Id.* at 20-31.

45 AT&T Comments at 10; *see also* Comments of the Ad Hoc Telecommunications Users Committee at 28-30 ("Ad Hoc Comments"); Comments of CoreComm Newco, Inc. at 3-4 ("CoreComm Newco Comments"); Comments of KMC Telecom, Inc. at 2 ("KMC Telecom Comments"); NEXTLINK Comments at 3; Comments of RCN Telecom Services, Inc. at 2-4 ("RCN Comments").

As noted above, the Commission must recognize that there are distinctions between the access and local exchange markets. These distinctions are most pronounced for high-volume access customers – such as large business customers – where the viability of competitive access arrangements do not depend on the competitive availability of local exchange service. For example, competitive high capacity transport service does not depend on the availability of UNEs and may allow end-users to bypass ILEC access services.

In addition, these arguments fail to acknowledge the level of competition in certain access markets and the degree to which this competition disciplines access services. As GTE explained in Section II.C, competition has developed in the transport market for high-volume access services. The loss of this high-volume end-user traffic in such a manner has a disproportionate impact on ILEC revenues when compared to some other measurement of market share, such as the number of lines or number of customers lost to competition. Notably, the migration of such traffic results in a significant reduction in universal service support to the ILEC because implicit subsidies remain in access charges. Further, it exacerbates the inefficient migration of end-users from switched to dedicated services due to competitive disparities.

The pricing flexibility proposal offered by USTA creates an appropriate mechanism by which the Commission may move toward a market-driven approach.[46] In particular, GTE supports the following pricing flexibility options: (1) price deaveraging rates for access elements; (2) volume and term discounts; and (3) relief for the

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46 *See* Comments of the United States Telephone Association at 29-38 ("USTA Comments").

introduction of new services by removing the public interest petition and cost showing requirements, and eliminating the codification of Part 69. These forms of relief should not be made contingent upon any competitive triggers beyond the basic requirements of USTA's Phase 1 plan. In addition, two other measures addressed by the USTA plan — replacement of price cap baskets and bands with a simpler structure and allowing ILECs to enter into customer-specific contracts for access services — should be incorporated into any Commission framework to implement pricing flexibility.

B. The Record Underscores The Potential Benefits Of ILEC Pricing Flexibility.

A number of parties describe the benefits that accompany pricing flexibility and the manner in which pricing flexibility may promote competition in the market for access services. As Robert W. Crandall notes in his declaration included with Bell Atlantic's comments, the establishment of pricing flexibility on an expeditious basis will play an important role in substituting "competition for regulation in local access/exchange markets" and "provides the opportunity for markets to replace regulators in determining how telecommunications services should be designed, marketed, and priced."[47] Indeed, the Ad Hoc Telecommunications Users Committee recognizes that pricing flexibility where competitive conditions are present "serves the public interest generally, because it holds the potential to send more accurate pricing signals to the market.

[47] Declaration of Robert W. Crandall, Exhibit 1 of Bell Atlantic Comments at 10 ("Bell Atlantic Exhibit 1").

Moreover, consumers could benefit from the lower prices and expanded choice that results from competition."[48]

Conversely, "[i]f incumbents are not permitted to vary their rates, as well as the terms and conditions of service, in response to entry, rates will not gravitate as quickly to competitive, market-based levels or, indeed, may never get there."[49] As SWBT correctly observes, "[c]ontinuing to deny LECs increased pricing flexibility prolongs the exclusion of [ILEC] suppliers from the competitive process" and thus perpetuates the economic inefficiencies that flow from the continued absence of pricing flexibility.[50] GTE concurs and urges the Commission to proceed expeditiously to pricing flexibility and grant ILECs increased relief from regulatory burdens in the following areas.

Deaveraging: As GTE explained above, deaveraging access rate elements is beneficial regardless of the level of competition because it allows carriers to more accurately reflect underlying differences in cost structures. Indeed, even Sprint recognizes the potential benefits associated with geographic deaveraging through zone-based pricing.[51] To this end, Sprint notes that affording ILECs flexibility should

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[48] Ad Hoc Comments at 25.

[49] Bell Atlantic Exhibit 1 at 11-12.

[50] SWBT Comments at 14.

[51] Comments of Sprint Corporation at 13 ("Sprint Comments"). In particular, Sprint suggests that the Commission allow ILECs to (1) "reprice their special access services and switched transport services in their existing density zones, based on costs and without regard to the constraints resulting from having required the same initial price cap index for each geographic zone" and (2) disaggregate its rates into four or more zones if the "ILEC believes that three density zones are insufficient for reflecting the cost differences throughout its service area." *Id.* at 13-14. In addition, Sprint proposes that the Commission "immediately initiate density zone pricing for other elements of

"give ILECs a fair opportunity to compete against other access transport providers that tend to concentrate in high-density areas while at the same time fully recovering their costs of serving less dense areas where competition has not yet emerged."[52]

Volume and Term Discounts: GTE urges the Commission to give ILECs the ability to offer volume and term discounts. As GTE explained in its Comments, such discounts reflect the underlying cost characteristics of the service and will not hinder competition.[53] Further, as USTA notes, volume and term discounts are strategies that "provide substantial benefits to customers and prevent inefficient investment in the network by more closely aligning customer preferences with costs."[54] Non-linear volume discounts allow the price the customer pays for units purchased at the margin to approach the incremental cost of providing those units, thus providing better price signals for customer purchase decisions. Because of the presence of economies of scale, it is not possible to achieve this with uniform prices, given that, if a uniform price were reduced to incremental cost the resulting revenue would not be sufficient to recover the firm's total cost.

Relief for the Introduction of New Services: GTE agrees with USTA that "[r]elief from regulation of new services is long overdue as the Commission should

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(...Continued)
switched access: local switching and NTS recovery charges (both flat-rated and MOU-based)." *Id.* at 14.

52 Sprint Comments at 14.

53 GTE Comments at 27-28.

54 USTA Comments at 37.

remove any rule which in any way hinders the introduction of a new service or delays the deployment of new technologies."[55] Because regulatory delay is unnecessary to protect competition, and indeed may ultimately harm consumers, such relief should be granted on an expeditious basis.

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In addition to taking action as proposed by USTA, the Commission should promptly adopt GTE's request for zone-based deaveraging of its switched access pricing in the form of its Zone Plus offering.[56] As GTE detailed in its Petition, this service incorporates elements of both geographic deaveraging and volume and term pricing flexibility measures. Significantly, the proposed ZonePlus discounts are based upon the end-users' traffic volume, rather than that of the IXC, so this service give IXCs of all sizes the ability to compete for a given end user.

In GTE's view, its proposed offering would allow it to more accurately reflect cost differences, while benefiting IXCs by allowing them to offer an expanded range of service options to their customers. Moreover, the ZonePlus offering would benefit customers without any potential adverse impact on competition. Indeed, a form of this service is available at the state level in California today and there have been no allegations of discrimination or adverse affects on competition.

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55 USTA Comments at 36.

56 *See* Petition For Waiver of the GTE Telephone Operating Companies (filed Nov. 27, 1995) (seeking authority to offer ZonePlus pricing in five initial study areas: California, Texas, Oregon, Washington, and Florida). Indeed, the fact that GTE's petition has been pending for almost three years illustrates the fact that the Commission should streamline its rules governing the introduction of new services.

C. Contrary To The Claims of ALTS and Others, Pricing Flexibility Will Neither Harm Competition Nor Consumers.

The categorical statements made by ALTS and others that immediate flexibility would "hurt consumers and stifle the competition that does exist and is continuing to emerge" fail to consider adequately whether the benefits of pricing flexibility outweigh any perceived harm in light of existing safeguards.[57] Most parties are notably vague about what such harms might be; of the parties who are specific, only discriminatory pricing is identified as a potential harm.[58]

GTE disagrees with the assumption underlying these claims that ILECs have the incentive and the ability to engage in such discriminatory conduct. Further, even if the ILECs had the incentive and ability to engage in such misconduct, ALTS and others fail to acknowledge that existing regulatory safeguards mitigate any potential harm. Most notably, Section 202(a) of the Communications Act already prohibits any carrier from engaging in "any unjust or unreasonable discrimination in charges, practices, or classifications . . . or services for or in connection with any communication service."[59] For example, in the context of contract based pricing, any such arrangements would have to be offered to any similarly-situated access customer under § 202(a) of the Act.[60] Such a requirement both prevents discrimination and creates powerful disincentives to engage in below-cost pricing.

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57 ALTS Comments at 6; *see also* AT&T Comments at 9.

58 *See, e.g.,* AT&T Comments at 9-11.

59 47 U.S.C. § 202(a).

In addition, the pricing flexibility contemplated by USTA and others does not suggest that access services are immediately removed from regulation under price caps. Price caps themselves further ensure that access rates are not too high through the constant downward pressure exerted by the X-factor. However, ultimately the most effective safeguard is to remove more competitive markets from price caps in order to eliminate any possibility that reductions in prices for more competitive offerings will create headroom under the cap which might allow increases in less competitive service rates.

The Commission should not simply take at face value the vague, conjectural, and self-serving claims of harm advanced by ILEC competitors. Instead, the Commission should identify any specific concern – if any – that is reasonably associated with each specific aspect of the proposed pricing flexibility. If a valid concern is found to exist, then an equally specific and targeted safeguard should be developed to protect customers against the specific anticompetitive behavior that gives rise to the concern. Each of these safeguards should be the least intrusive, and least distorting, regulatory tool that will do the job. This approach will allow the Commission to approach the issue of pricing flexibility in a constructive manner that can lead to specific, positive results, and minimize the simplistic name-calling that has characterized much of the debate on this matter.

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[60] 47 U.S.C. § 202(a).

D. The Commission Should Reject MCI WorldCom's So-Called Pricing Flexibility Proposal.

In its comments, MCI WorldCom offers a "pricing flexibility" proposal that seeks to grant limited flexibility only after the Commission determines, on a case-by-case basis, that an ILEC faces "substantial competition" in particular markets.[61] Notably, MCI WorldCom suggests that such a framework apply only to transport services (defined as trunking basket services other than the TIC), and ILECs who demonstrate "substantial competition" would be "permitted to file contract tariffs that are generally available to similarly situated customers."[62] There are three primary problems with MCI WorldCom's proposed approach.

First, as GTE explained above, some forms of pricing flexibility, such as geographic deaveraging and volume and term discounts, benefit end-users regardless of the degree of competition because they allow ILECs to more accurately reflect differences in underlying cost structures. Accordingly, the need for pricing flexibility in these areas is not confined, as MCI suggests, to narrow market segments and types of customers where "substantial competition" exists. Rather, such measures should be instituted broadly across all market segments given the fact that they do not depend on a particular level of competition.

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[61] MCI WorldCom Comments at 49-55.

[62] *Id.* at 45. In addition, without elaboration, MCI provides that when a carrier demonstrate it lacks market power, it would be declared non-dominant and be "permitted to remove services from price-cap regulation, and would be subject to non-dominant carrier tariff rules." *Id.*

Second, MCI WorldCom's arguments rest largely on the faulty assumption that all forms of pricing flexibility should depend upon the opening of all local exchange access markets to competition.[63] As GTE explained above, there are important distinctions between the market for access services and the market for local exchange services relevant to the purpose of granting regulatory relief. For this reason, the USTA plan would allow the relevant market for access services to multiline business locations to be evaluated separately from the market for services to residence and small business locations. For reasons discussed above, customers in the multiline business segment may have ample choices of alternative supply for their interstate access needs. This form of competition is independent of the presence or degree to which local competition exists broadly in other markets, such as residential markets.

Third, the regulatory framework suggested by MCI WorldCom will only create regulatory delay that will render ILECs ineffective against their unshackled competitors. It is simply inconceivable, as MCI WorldCom would suggest, that a potential access customer would agree to wait the inevitably lengthy time required for an ILEC to petition the Commission for pricing flexibility, respond to the likely objection of MCI WorldCom and other competitors, and receive approval for the contract tariff (which MCI WorldCom would require only after the passage of an entire year). Any such so-called "flexibility" that denies consumers the benefits of the potential services offered by ILECs on a prompt basis in no way furthers the public interest.

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63 *See* MCI WorldCom Comments at 44.

Accordingly, the Commission should reject MCI WorldCom's self-serving attempt to impede competition by creating regulatory "roadblocks." Instead, the Commission should implement pricing flexibility for ILECs in the manner suggested above. These measures are a necessary second step to allow the marketplace to operate and move access rates to market-based levels.

IV. THE COMMISSION SHOULD DECLINE TO FOLLOW THE VARIOUS SUGGESTIONS TO "REFORM" ACCESS CHARGES THROUGH PRESCRIPTIVE MEANS.

The Commission should not adopt a prescriptive approach to access reform. There is no sound policy basis for the Commission to change course now. As discussed below, all prescriptive approaches suffer from the same general infirmities. They will: 1) stall the continued development of actual competition in the access market, 2) undermine the benefits that the Commission's price cap rules have produced, and 3) lead to an illegal taking. Further, it would not make sense to judge the effectiveness of the Commission's efforts to facilitate competition prior to the year 2001 without significant and substantial new economic justification provided by the IXCs. In particular, GTE discusses in detail below the unique problems and substantial legal difficulties found in each of the prescriptive plans proposed by MCI WorldCom, CompTel and others.

A. A Prescriptive Approach To Access Charge Reform Would Be Unlawful And Bad Policy.

The Commission should reject as premature any suggestions to turn to an arbitrary prescriptive approach only one and one-half years after the *Access Reform*

Order was adopted. Several commenters, including MCI WorldCom, Sprint, and AT&T, suggest that the Commission should prescribe access charges.[64] As discussed more thoroughly below, there is no sound basis for the Commission to move to a prescriptive approach, particularly in light of the fact that a prescriptive approach is an imperfect substitute for competition.

1. A number of commenters echo GTE's concern that there is no sound policy basis upon which to adopt a prescriptive approach.

A number of commenters, including several competitive providers, echo GTE's concern that there is no sound policy basis upon which to prescribe access charges.[65] As NEXTLINK explains, "[t]he use of a prescriptive approach in the midst of market-driven reform could chill the current positive environment for CLEC investment and freeze the development of actual competition in the access market."[66] Further, a prescriptive approach is bad economic policy. "[T]here is no economic justification for pushing rates to incremental cost as a proxy for pricing in a competitive market."[67]

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64 *See* AT&T Comments at 3; *see also* MCI WorldCom Comments at 9; Sprint Comments at 6.

65 *See* Bell Atlantic Comments at 3-11; *see also* Comments of BellSouth at 4-12 ("BellSouth Comments"); Comments of Cincinnati Bell Telephone Company at 4-8 ("Cincinnati Bell Comments"); USTA Comments at 10-13; Time Warner Comments at 3; NextLink Comments at 4; ALTS Comments at 6.

66 NEXTLINK Comments at 4-5.

67 Bell Atlantic Comments at 4.

Adopting prescriptive rates would "undermine the benefits that the Commission's price cap rules have produced."[68]

Nonetheless, the Commission is once again asked to consider arguments for a prescriptive approach to access reform despite $2.4 billion reductions in industry-wide access charges during the past 18 months. The Commission correctly declined to adopt such a far-reaching, prescriptive scheme in its *Access Reform Order.* Instead, the Commission decided to give competition the chance to develop by its proposed February 8, 2001 review. It would be "imprudent to prejudge" the effectiveness of the Commission's efforts to facilitate competition prior to the year 2001,[69] especially without significant and substantial new economic justification provided by the IXCs. This is true particularly because the FCC has failed to implement its market-based approach as promised. Because there is nothing new in the IXCs' arguments, there is no basis for the FCC to change course now.

2. Regulatory provisions are an imperfect substitute for market forces.

As Time Warner argued in its Comments, "[m]arket-based policies continue to represent the preferred means of accomplishing public interest objectives."[70] The Commission has already agreed with this view. In the *Access Reform Order*, the

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68 *Id.* at 3.

69 *Id.* at 5-7 (citing *Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing, End User Common Line Charges*, 12 FCC Rcd 15982, 16097 (1997) ("Access Reform Order").

70 Time Warner Comments at 3.

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."[71] Competition, it concluded, leads to efficient allocation of resources and services, and "a better combination of prices, choices and innovation than can be achieved through rate prescription."[72]

The market-based approach is superior not only because of the benefits enumerated above, but also because of the problems inherent in a more draconian regulatory approach. The uncertainty of how to use past performance in order to predict future productivity "can have anomalous effects on individual ILECs."[73] Time Warner also recognized deficiencies in moving to a regulatory-based approach when it recommended that the Commission should reject requests for prescription. It concluded that "[a]ny efficiency gains resulting from a prescriptive approach are static, one time events that require maintenance through regulatory oversight, with no assurance that the resulting rates reflect the underlying cost of providing the service."[74]

Now, however, several commenters, including Sprint, MCI WorldCom, and AT&T, want to disregard the benefits of a market-based approach and ignore the problems inherent in that regulatory approach. The Commission must reject these proposals and answer the call of several commenters to give the market-based

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[71] *Access Reform Order*, 12 FCC Rcd at 16601.

[72] *Id.* at ¶ 289; *see also* Bell South Comments at 11-12 (explaining that a prescriptive approach would "negatively affect investment and innovation."). *Id.*

[73] *Id.*

[74] Time Warner Comments at 3.

approach time to work once the FCC fully implements its plan as outlined by GTE.[75] Access competition is developing rapidly, which will accelerate with the market-based reforms. Further, neither the record in this proceeding nor sound economic theory offers any basis to alter the Commission's conclusion that prescribing access charge rates is "at best an imperfect substitute for market forces."[76]

3. Claims by IXCs and others that rates and earnings are too high are invalid justifications for prescription and are inconsistent with the Commission's goal of promoting competition.

A number of the IXCs submit that the Commission must prescribe access charges because both access rates and ILECs' earnings are too high.[77] GTE disagrees with the attempt to justify prescription because of earnings levels for five reasons.

First, prescribing rates because earnings are too high would be contrary to one of the main benefits of price caps – rewarding companies for efficient operation.[78] As AT&T argued in its *1993 Price Cap Performance Review*, "any attempt to eliminate or

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[75] Bell Atlantic Comments at 6-7; *see also* Time Warner Comments at 4. ("The Commission must allow additional time for meaningful competition to develop and there is substantial evidence that the process has already begun.").

[76] *Access Reform Order*, 12 FCC Rcd at 16107; (However, as discussed above, the Commission must remove implicit subsidies for competition to flourish. The Commission must complete its reform of federal universal service support mechanisms by removing all implicit subsidies from access charges and replacing them on a dollar-for-dollar basis with explicit universal service funding. ILECs cannot be competitive if implicit subsidies prevent them from competing with competitive access offerings that do not contain such subsidies. CLECs, on the other hand, cannot be expected to effectively compete against ILECs for services that are receiving the benefit of such subsidies.).

[77] *See, e.g.,* MCI WorldCom Comments at 9-11.

recapture the profits resulting from such higher efficiency would not only breach the promise of price cap regulation, but destroy the incentive to make the difficult decisions necessary to yield the additional efficiency gains in the first place."[79] Further, as USTA details in its Reply Comments, AT&T has argued in the past that all price cap benefits flow from the potential for increased profitability.[80]

Second, ILEC earnings based on regulated depreciation rates are deceptive. If ILECs were allowed to use economic depreciation, their earnings would be considerably lower. For example, if an ILEC's composite depreciation rate were only 1 percent higher, annual reported earnings would be reduced by approximately 1.4 percent.[81] However, ILECs do not have the ability to choose completely how to depreciate their equipment. Instead, unlike the IXCs, depreciation rates are constrained by regulation below economically rational levels. As a result, the IXCs' use of earnings as support for their call for prescribed rates is flawed.

Third, MCI WorldCom's declaration that the RBOCs continue to report record monopoly profits is not sufficiently supported in its Comments.[82] The actual data

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78 *See* Bell Atlantic Exhibit at 9-10.

79 Comments of AT&T, CC Docket No. 92-134 (filed Sept. 4, 1992); *see also* Bell Atlantic Comments at 3.

80 *See generally* Reply Comments of USTA, CC Docket No. 96-262, CC Docket No. 94-1, CC Docket No. 97-250 and RM- 9210 (to be filed Nov. 9, 1998) ("USTA Reply Comments") (citing Comments of AT&T in CC Docket No. 92-134 (filed Sept. 4, 1992)).

81 *See generally* USTA Reply Comments.

82 MCI WorldCom Comments at 9-11.

attached as Appendix A, entitled "RBOC Financials," have little meaning alone and certainly do not support any conclusions as to rate-of-return or monopoly profits.[83] Further, MCI WorldCom uses corporate holding company performance instead of ILEC performance to support its claims.[84] This misapplication extends into MCI WorldCom's Attachment A. Earnings from interstate access represent approximately one-third of total company earnings, and thus, total company earnings are not an accurate measure of the rate of return for interstate regulated offerings.[85] Finally, in a competitive industry, the goal and the expectation is that the net income and earnings of competitive firms will increase over time.[86] Thus, no adverse inference should be drawn from MCI WorldCom's estimates.

Fourth, arbitrary rate reductions are unnecessary in the face of increasingly competitive access markets.[87] 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.

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[83] *See generally*, *Affidavit of Dr. Larry F. Darby*, attached as an Exhibit to USTA Reply Comments. ("Darby Affidavit") (The ratios presented in MCI's Appendix have very limited analytical content without complimentary data on assets and capital.) *Id.*

[84] *See generally* USTA Reply Comments.

[85] *Id.*

[86] *See* Darby Affidavit.

[87] Bell Atlantic Comments at 7-8 (quoting Chairman Kennard's statement that local competition will grow with "the type of steadily increasing momentum that we saw with the introduction of competition into the long distance market."). *Id.*

Finally, as discussed above, arbitrary access rate reductions will transfer revenues from ILECs to IXCs, without providing for the recovery of legitimate ILEC costs. 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 only through explicit universal service support.

As for ILEC arguments that rates are too high, GTE notes that it is widely recognized that interstate access rates are higher than what a competitive market would set, given the underlying cost of providing access and the demand for the service. However, as the Commission has explained, price caps are designed to ensure that rates are reasonable.[88] Price caps are a "transitional regulatory scheme until the advent of actual competition makes price cap regulation unnecessary."[89]

The dichotomy between current rates and those that a competitive market would set reflects historical policy choices made by regulators to retain implicit subsidies in access rates.[90] 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 WorldCom, AT&T and CompTel.[91]

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88 *Price Cap Performance Review For AT&T*, 8 FCC Rcd 5165, 5166 (1993).

89 *Price Cap Performance Review for Local Exchange Carriers*, 10 FCC Rcd 8961, 8965 (1995).

90 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.

91 See MCI WorldCom Comments at 2-6; *see also* AT&T Comments at 3-8; CompTel Comments at 4-5.

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.

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No matter what justification is offered by commenters, a move to prescribe access charges is not prudent. In fact, as Cincinnati Bell states, "[t]hose who think that the Commission mandating access rates at cost-based levels will magically result in an efficient, competitive marketplace are not being realistic."[92] GTE argues that over time and with Commission action on universal service funding and pricing flexibility, competition will develop. Therefore, the proposals submitted by the IXCs are untimely and unnecessary.

B. The Specific Prescriptive Plans Proposed By MCI WorldCom, CompTel And Others Each Raise Substantial Legal Questions.

1. Claims by AT&T, MCI WorldCom, Cable and Wireless and others that the Commission should develop hypothetical cost models to prescribe access rates are inappropriate in light of the Commission's goal of developing a market-based system.

Several parties have suggested that the development of a forward-looking cost model by the Commission should provide a justification for the prescription of access

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92 Cincinnati Bell Comments at 5.

rates.[93] GTE agrees that the estimates derived from a correctly formulated forward-looking model may be useful in a number of ways. However, they do not provide a reasonable basis for establishing a new level of overall cost for the ILEC industry or for individual ILECs, and therefore do not provide a basis for an arbitrary represcription of access rates.

A correctly formulated forward-looking cost model may be useful in providing information on the relative levels of the direct, or TSLRIC cost of access services, and of local services. These values will provide guidance as to how much of the total current cost recovery of the ILEC each service should bear, if rates were to be rebalanced to reflect their relative costs. The difference between the revenue produced by these rebalanced rates and the current rate levels provides a reasonable measure of how much implicit support each service now generates or receives.

As discussed above, for access services, these estimates will show that the current switched access charges generate about $5.9 billion more than would rebalanced access rates. This difference represents the implicit support provided by interstate access rates today. This amount should be replaced by explicit universal service funding, which would allow access rates to be reduced to their rebalanced level.[94]

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93 MCI WorldCom Comments at 25; Comments of Cable and Wireless USA at 7; AT&T Comments at 7-8.

94 Note that when implicit support is estimated in this way, a *lower* estimate of the TSLRIC cost of interstate switched access would produce a correspondingly *higher* estimate of the implicit support that access provides.

For local services, these estimates would show that rebalanced local rates would generate billions of dollars more than do the current local rates, which state commissions have set in order to meet affordability goals. This shortfall represents the amount of implicit support that local services receive from interstate access and from intrastate services (such as state access, toll, and vertical services) that generate implicit support today. A sufficient federal universal service fund would replace the portion of this shortfall that is provided today by interstate access rates.

A correctly-formulated forward-looking cost model will also provide useful information concerning the relative level of local service cost in each small geographic areas. These estimates will be useful in apportioning support levels to reflect relative differences in cost across these small geographic areas.

2. The Commission should not arbitrarily change the basis on which it determines ILEC costs.

The process described above is based on information on the relative levels of direct cost for each major ILEC service category. The forward-looking cost model is a useful source of this information. However, there is no reason why the Commission should abandon its current method of regulating the overall level of ILEC costs. Indeed, there are several good reasons why it should not do so.

Through the Commission's history, it has relied on three basic methods in order to establish a value of the assets of the firms it regulates, and to derive the overall level of cost recovery it will permit. In the early years of regulation many regulators employed a system of fair value regulation. Under this approach, the regulator periodically attempts to assign a value to the regulated firm's assets by estimating their replacement costs. This early approach was supplanted in the 1930's by rate-of-return regulation, which valued the firm's assets based on the costs the firm incurred to buy them, adjusted for depreciation. In 1990, the Commission abandoned rate-of-return regulation in favor of price caps, in which the Commission estimates the firm's cost recovery in the prospective year by trending the recovery levels from previous years.

What MCI WorldCom and other parties in this proceeding are suggesting is that the Commission should return to a form of fair value regulation. The forward-looking models would perform the role that replacement cost studies once provided. In effect, this proposal amounts to a "back-to the future" return to a form of regulation the Commission abandoned sixty years ago.

All of this ignores the simple fact that regulators abandoned fair value regulation for good reason. Supreme Court Justice Steven Breyer explains why:

> Why then do regulators not value rate base at replacement, rather than historical, cost? Indeed, for many years, they sought to do so, but the change to historical cost reflects one important administrative fact: to determine the replacement cost of a plant or equipment is too complex a task for an administrative process.[95]

GTE submits that this methodology is antithetical to the 1996 Act's deregulatory goals and should not be adopted.

Justice Breyer goes on to explain, by means of an example, why this determination is impractical for a regulator:

> Consider, for example, a public utilities commission trying to value a coal-fired 200-megawat power station built in 1920 and located one hundred miles north of Boston. Its replacement value equals the cost of producing the 200 megawats from a modern plant with efficient, modern equipment. But to

95 Steven Bryer, *Regulation and Its Reform* 38 (1994).

> establish that cost one would have to determine, for example, (1) whether the new plant would use coal, oil, natural gas, or nuclear fuel, (2) whether the new plant would be 200 megawats in size or larger, (3) where the plant would fit within the multistate integrated network of power plant facilities, (4) the cost of the land used for the plant, (5) expected construction delays, (6) the effect of the new plan on the optimal cost configuration of other future plants, (7) what environmental safeguards would be necessary, and (8) the cost of likely delays in obtaining regulatory permissions. Each of these decisions – including those governing site-acquisition costs and the restructuring of the total network of plants and transmission lines, which becomes desirable once one assumes a new plant rather than an old one – would be made hypothetically. But each is necessary to determine the hypothetical cost of a new plant and therefore the valuation a current market price of the old plant. . . .
>
> [O]ne can see how highly qualified experts could argue both sides of these questions in great detail, with "company experts" placing a high value on the plant and "consumer experts" a low one. The arguments would be lengthy, the technical evidence extensive, and the result largely a matter of judgment. The possibility of court review finding the judgment "unreasonable" would make ratesetting uncertain.[96]

To reduce this uncertainty, commissions using a "fair value" or "reproduction cost" standard tried simply to estimate what it would cost to replicate exactly the existing plant. But, as Justice Breyer points out, this destroyed any possible value the replacement cost approach might have had. "It would, for example, allow inclusion of an expensive plant in the rate base despite technological change that destroyed the value of the existing plant. The more obsolete the plant, the higher might be the rates."[97]

To avoid this result, and recognizing their inability to estimate replacement costs, commissions abandoned fair value regulation in favor of regulation based on historical

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[96] *Id* at 39.

[97] *Id.*

costs, adjusted for depreciation.[98] When the Commission replaced this historical cost system with price caps for ILECs in 1990, it did so because it found the price cap method to be the best available means for ensuring that the overall level of ILEC cost recovery through rates would reasonably match the overall level of ILEC costs over time. Price caps would also correct some of the alleged distortions of rate-of-return regulation, and provide better incentives for ILECs to improve efficiency.[99]

Nothing has happened since 1990 to change this conclusion. Price caps have provided an effective means for measuring *overall* ILEC costs. Price caps have prompted ILECs to become more efficient overall, which has allowed access rates to be cut approximately in half since 1990. However, the price cap mechanism, by itself, is not a tool for correcting large relative imbalances in rates.[100] Access rates are still

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98 The Supreme Court ratified this change of approach in the Hope Natural Gas case in 1944. *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). Note that depreciation, if estimated correctly, should capture the decline – discussed by Justice Breyer -- in the value of plant due to technological change. The depreciation rates prescribed by the Commission have not adequately captured this effect.

99 Since 1990, more than half of the states have also adopted some form of price cap or incentive regulation. This approach thus covers the preponderance of ILEC revenues and costs nationwide.

100 Given reasonable pricing flexibility, a price cap system *can* allow relative rate levels within the access structure to be fine-tuned over time; this is the correct application of the Commission's "market-based" approach. Ordover and Willig, in their statement attached to AT&T's Comments, fail to appreciate this fact. Janusz Ordover and Robert Willigs, *On Reforming the Regulation of Access Pricing*, Attachment A to AT&T Comments. They claim that price caps have failed, because they have not eliminated the imbalance in access rates, relative to the rates for other ILEC services. As indicated in the text above, price caps was not designed for this purpose; price caps have performed their intended function of bringing rates down over time to reflect changes in the ILECs' overall cost level.

relatively high today because they still contribute implicit support to universal service, and they need to be rebalanced to replace this implicit support with explicit funding. Parties who complain that price caps have not accomplished this rebalancing simply miss the point that this is not the function that price caps are intended to perform. Price caps do not provide a means for identifying the portion of current access revenues that should be recovered through universal service funding.

The Commission should continue to rely on its price cap mechanism to measure the overall level of cost recovery that it should permit ILECs. As competition develops, the next stage in the evolution of the Commission's policies should be the removal of markets from price caps as competitive conditions warrant. This is the kind of increased reliance on market forces, rather than traditional regulation, that the Act contemplates. It would be antithetical to the policy direction established in the Act for the Commission to establish, by fiat, an entirely new price level for the industry. It would be even more unreasonable for the Commission, having developed and refined price cap regulation, to revert to the fair value approach, a method of regulation that it abandoned – for good reason – many years ago.

3. The cost models do not provide a basis for changing the overall cost level determined by price caps.

Even if the Commission wished to establish a new cost level by fiat, it does not have the means at hand to do so. The kinds of difficulties enumerated by Justice Breyer in his power plant example are also encountered in the measurement of forward-looking costs for telecommunications services. His description of contentious arguments among "experts" for each of the parties sums up very well the process that has been going on before the Commission for the last three years in establishing a cost model to determine high cost recovery for non-rural LECs. The staff has made progress in improving the design of the "platform" for the Commission's forward-looking cost model. However, the staff's work, no matter how good, cannot alter the fundamental nature of the exercise: it is simply not possible to produce a simulation model that will reliably predict the efficient, forward-looking level of total cost for a LEC.

This is partly due to the kinds of difficulties Justice Breyer sets forth in his example. The model creates only a representation of reality. The choices which will determine the model's output are largely matters of judgment. In particular, unless one accepts the current level of ILEC cost as a reasonable point of comparison, there is no reference point of forward-looking cost available outside the model against which the model's estimates can be tested and verified.

The limitations of the modeling approach go well beyond the items Justice Breyer lists. A real firm that intends to operate over some planning horizon will seek to maximize profits and minimize costs, not for a particular moment, but over that planning horizon. Because the model is static, it cannot represent the tradeoffs a firm must make to optimize efficiency over time. For example, a firm might choose to replace a switch this year, or to wait until next year. Next year's model might be cheaper, or more capable than this year's. The cost of waiting would be the benefits the firm might realize over the intervening year from the switch bought this year.[101] Similarly, the firm

[101] These tradeoffs have been explored in the recent "real options", which applies the theory of financial options to the analysis of real investment decisions by a firm over time. See, for example, Dixit, Avinash & Robert Pyndyck, *Investment Under Uncertainty*, Princeton University Press, 1994.

must plan for growth in market demand, and for gains or losses in market share, over time. Standard economic models of this problem involve tradeoffs among capacity utilization, placement costs, and the size of the units of equipment to be placed.[102] These choices are complicated by uncertainty about future changes in demand, input prices, technology, and so on. In the real world, both incumbents and entrants must make difficult choices to optimize costs over time.

The models have no representation of time, and thus no means for capturing these tradeoffs. By ignoring these tradeoffs, the model may ignore a very real component of determining long run, forward-looking costs. Further, as GTE noted in its Comments, the model simulates the physical network plant, which is only a portion of the firm's production process. For example, the model does not try to simulate the operation of the billing system, the network engineering activities, or corporate finance. Instead, it makes allowance for these costs, many of which are common, through rough estimates of what these costs ought to be. Debates among the parties about the level of these types of "forward-looking" expense has generally been of the "tastes great" vs. "less filling" variety, precisely because there is very little real evidence of how "forward-looking" expenses should differ from current expense levels of the ILECs.

At base, the model will produce cost estimates that include the accumulated effects of the various sources of possible error listed here. All the Commission's

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102 These models, often referred to as S,s models, generally involve a sequence of investments over time, increasing capacity in a "stair-step" process to track the growth in demand. The firm must choose the optimal size of each "step", and the time interval between steps, to minimize cost for a given standard of quality over the planning horizon.

experience with cost models would lead one to believe that the error in the model's estimates is quite large. Therefore, the model simply does not provide a basis for a conclusion that the overall level of ILEC cost recovery should be changed by prescriptive means. Instead, the Commission should rely on its existing price cap mechanism, which derives a permitted level of cost recovery for the ILECs based on a trend of aggregate productivity from the recent past.

4. MCI WorldCom's proposal to simultaneously combine prescriptive rate reductions with upward adjustments to the X-Factor is a flawed approach that would result in an unconstitutional taking.

In its comments, MCI WorldCom recommends that the Commission prescribe access charges by "immediately open[ing] a supplementary proceeding to establish forward looking cost levels for access."[103] MCI WorldCom also recommends that the Commission simultaneously increase the X-factor to 9.2% and retroactively adjust PCIs based on this amount back to the 1995 access year.[104] This multi-faceted ratcheting down of access rates is the equivalent of regulatory piling on. Even in football such an action would lead to a stiff penalty. If the Commission follows MCI WorldCom's suggestions, it will set access charges below an ILEC's actual costs. Clearly this argument is flawed. It would represent an illegal taking of an ILEC's property without just compensation.

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103 MCI WorldCom Comments at 25.

104 *Id.* at 28-29.

MCI WorldCom contends that "reducing access charges to their economic cost would enhance productive efficiency [because] ILECs will have an increased incentive to become more efficient."[105] However, ILECs always have an incentive to become more efficient. Cutting rates to cost will not provide more of an incentive. This argument is further flawed because MCI WorldCom's proposes simultaneously to increase the X-factor in order to confiscate any increase in efficiency. This result would ultimately harm consumers and is counter to the Commission's stated goals. When the Commission established the productivity offset, it set as its target the maximum sustainable rate reductions while still promoting innovation and efficiency.

Even Sprint has recognized the fatal flaw in MCI WorldCom's proposal. "[O]nce access charges of a particular carrier reach economic costs, it may be unfair to continue to apply the industry X-factor to that carrier [and] it may be incumbent on the Commission to cease applying the X-factor."[106] Sprint believes that the reason why the local telecommunications industry is productive is because ILECs have an incentive to replace old equipment. Any application of the X-factor after access charges reach cost could threaten that incentive and, as discussed above, harm consumers. Further, retroactively ratcheting down the PCIs to prior years clearly undermines those incentives and clearly forces prices down to a level where costs are too low.[107]

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105 *Id.* at 22.

106 Sprint Comments at 7.

107 As demonstrated in Section V.A., *infra*, the X-factor has already been set too high and, therefore, should not be increased further.

5. CompTel's "Prescriptive Transition Plan" is simply another attempt to initiate prescriptive rates at the expense of the Commission's chosen price cap scheme.

In its Comments, CompTel proposes a "Prescriptive Transition Plan" that prioritizes access reform, beginning first with those access rate elements which it concludes are not now, and are not likely to become, subject to any significant competitive pressures.[108] CompTel believes that such charges should be reduced to cost-based levels immediately, using the forward-looking costs of functionally equivalent UNEs, as determined by state commissions.[109] CompTel recommends that: (1) all tandem-related charges be reduced to cost, effective with the 1999 Annual Access Tariff filing; (2) all non-cost-based charges for terminating access be eliminated no later than July 2000; and (3) all other access rate elements be reduced to cost no later than July 2001.[110] This plan is not significantly different from those offered by MCI WorldCom, AT&T or other commenters who support a prescriptive approach to access charges.

As discussed above, a market approach to access charges is preferred over any prescriptive approach. The fact that CompTel's plan is phased in over time and uses UNE rates set by the states does not camouflage its true motive: to jam down access rates to confiscatory levels. It also does not change the economics of a prescriptive approach. CompTel is simply proposing a more detailed prescription plan. The result,

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108 CompTel Comments at 4.

109 *Id.*

110 *Id.* at 5.

as indicated previously, would be an abandonment of price caps and injury to consumers and investors.

CompTel's proposed use of state interconnection rates is also seriously flawed. Cost standards that have been adopted by regulators for interconnection differ from access charges.[111] Not all services can be priced at incremental costs as they are in interconnection proceedings. That methodology fails to allow for recovery of all overhead costs. GTE argues that a firm as a whole must be allowed the opportunity to recover its overhead costs. Access charges have been a source of such recovery in the past and should continue to be in the future. Under CompTel's plan, all of the burdens of overhead and embedded cost recovery would be on local service, resulting in a subsidy to long distance providers and harm to local ratepayers. While GTE believes that all implicit subsidies should be removed, the Commission should not adopt a plan that creates a subsidy that flows to IXCs at the expense of local ratepayers. The Commission should therefore dismiss CompTel's PTP.

6. Washington Utilities' proposal to prescribe terminating access charges is deficient.

The Washington Utilities and Transportation Commission ("WUTC") "recommends that the Commission require that interstate terminating access charge

[111] The Commission has traditionally used fully distributed costs and now uses price caps to set access charges . In comparison, interconnection charges are "based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection . . .." 47 U.S.C. § 252(d)(1)(A). Most states have used incremental costs plus a portion of overhead to set interconnection pricing. The IXCs have never explained why the standard of Section 201 should now be changed to match the standard used in interconnection proceedings.

rates . . . be priced in parity with the lowest reciprocal compensation rate in each exchange . . .. To price terminating access charges in parity with local interconnection will create technological and competitive neutrality . . . ."[112] Further, WUTC concludes that the distinction between local and toll calls is disappearing and recommends that the Commission adopt a plan that reflects that conclusion. Under the plan, carriers are supposed to be able to offset terminating access charge reductions with increases in originating access charges. The WUTC plan is flawed for the following three reasons.

First, moving subsidies from terminating access charge rates to originating and then exposing them to competition is simply another form of confiscatory prescription. As discussed above, the first step in access charge reform must be the removal of all implicit subsidies from access charges, and these subsidies must then be replaced on a dollar for dollar basis with explicit mechanisms. The Commission should not simply shift the subsidies from terminating to originating rates as WUTC suggests.

Second, if the Commission accepts WUTC's proposal, it would be adopting an entirely new approach to regulation. If the FCC prescribes terminating access rates, it must do so for all LECs because the WUTC's bottleneck theory applies equally to ILECs and all other LECs. This represents a fundamental shift from regulating only the incumbent's rate during the transition to competition.

[112] Comments of the Washington Utilities and Transportation Commission at 4-7 ("WUTC Comments").

Third, contrary to WUTC's claim, the plan is not "revenue neutral."[113] GTE, for example, will not be able to use originating access charges to recover all of the losses it would incur if the plan were implemented. Business customers that represent a significant amount of traffic can now bypass all originating access charges by purchasing direct access from IXCs. Such bypass would increase rapidly since CLECs would not be placed under the same constraints as ILECs. As a result, it is probable that a substantial amount of the revenue lost under the WUTC plan will never be recovered. Accordingly, the Commission should not adopt the WUTC plan in light of these flaws.

7. Ad Hoc's use of an X-Factor adjustment to arrive at cost-based access charge rates is counter to the Commission's price cap plan.

In its Comments, Ad Hoc contends that because competition has failed to develop, "the Commission must exercise its rulemaking authority to move to a forward-looking economic cost basis for interstate access rates."[114] To accomplish this goal, Ad Hoc proposes that the Commission raise the X-factor.[115] GTE disagrees strongly with Ad Hoc's recommended use of the X-factor to drive prices down.

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[113] WUTC Comments at 10 (WUTC believes its program is revenue neutral because the State "provid[es] incentives for carriers to rebalance their rates within access charges by allowing a 'free pass' on increases to originating access charges to offset any required terminating access charge reductions." GTE, as discussed above, believes that competition in the state of Washington will prohibit full recovery of access charge reductions.).

[114] Ad Hoc Comments at 3.

[115] *Id.*

The X-factor is not the appropriate tool to adjust access charge levels. Price caps were designed to keep cost recovery reasonable across all services, rather than achieving cost-based pricing for specific access rates. As Sprint correctly observes, the use of an X-factor to manipulate costs is "an uncertain task."[116] Relying on a single industry-wide X-factor is an extremely blunt instrument and will not even begin to approximate the correct cost-based level for access charges. In fact, some ILECs may be forced to price access services below cost if the Commission chooses an X-factor that is too high.[117]

8. Ad Hoc's "Make Whole or Make Money" proposal will neither make ILECs whole nor make them money.

Ad Hoc proposes that the Commission offer ILECs an alternative to a fully prescriptive approach. The "Make Whole or Make Money" proposal "would allow ILECs to choose between . . . guaranteed recovery of their embedded accounting costs . . . under Commission oversight of their earnings and pricing [and] prescription of access rates at economic (TSLRIC) levels, but with pricing flexibility and no regulatory restraints on earnings."[118] However, Ad Hoc's plan is empty rhetoric because it does not purport to be what it describes and therefore offers ILECs only a Hobson's choice.

Under the "Make Whole" approach, the Commission would be required to monitor ILECs' earnings and pricing. As discussed above, earnings should not be a

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116 *See* Sprint Comments at 6.

117 *Id.* at 7.

118 Ad Hoc Comments at 33-34.

factor in access charge decisions. When the Commission initiated price caps, it presented ILECs with an opportunity to make a profit and make themselves attractive to investors as long as they were efficient. The "Make Whole" approach would remove the incentive for efficiency and would harm both consumers and investors. It also fails to address the need for pricing flexibility as described in Section III. Absent pricing flexibility, CLECs will cream-skim certain business customers, thereby eliminating ILEC revenues and hence full recovery of costs. Thus, the approach would not make ILECs whole.

Under the "Make Money" approach,[119] ILECs must subject themselves to a prescription. Again, as discussed above, prescribing prices is an inferior alternative to competition that also would harm consumers, investors and competition. Because a prescriptive approach using TSLRIC does not permit adequate cost recovery, GTE fails to see how this plan permits ILECs to make money. As a result, Ad Hoc's plan will neither make ILECs whole, nor make them money.

V. THE COMMISSION SHOULD DECREASE THE X-FACTOR BASED ON A COMPANY-WIDE TOTAL FACTOR PRODUCTIVITY ANALYSIS.

A. The X-Factor Was Set Too High.

A careful examination of the record of price cap performance over the past two years and the first round of comments in this proceeding shows that the 6.5% X-factor

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119 Ad Hoc fails to describe what level of pricing flexibility it would find acceptable. Complete pricing flexibility probably would allow adequate recovery, but this can not be what Ad Hoc means since it is difficult to see why a prescription to TSLRIC makes any sense if ILECs can then simply reprice services to higher levels after the initial prescription.

was set far too high in light of past LEC productivity achievements and expected LEC productivity in the future.[120] While GTE has addressed in detail the shortcomings of the Commission's *Price Cap Order*[121] in its pending appeal,[122] those issues and the ILECs' recent experience under price caps show that a reduction in the X-factor is appropriate.

The Commission's 1997 result-oriented manipulation of the X-factor in order to achieve a predetermined level of access charge reductions was not a product of reasoned decisionmaking and ultimately set the X-factor too high. More specifically, the Commission disregarded the two lowest X-factor averages (the five and ten year averages), while including outliers at the high end of the spectrum.[123] Second, the Commission based its decision to place the X-factor near the top of its "range of reasonableness" given its conclusion that there was a "strong upward trend in productivity growth from 1992 to 1995."[124] It is not at all clear that such a trend existed in light of the particularly low 1992 figure, and, as shown below, USTA has now presented compelling evidence that such a "trend" analysis is inconsistent with more recent X-factor figures. Third, the FCC placed an unreasonably high level of reliance

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120 GTE believes it must respond to the comments and petitions for reconsideration filed in this proceeding to protect its interests in the event the Commission were to act on the petitions for reconsideration or the comments before the Court acts on GTE's petition for review.

121 *Price Cap Performance Review for Local Exchange Carriers; Access Charge Reform*, 12 FCC Rcd 16642 (1997) ("*Price Cap Order*").

122 *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).

123 *Price Cap Order*, 12 FCC Rcd at 16696-97.

124 *Id.* at 16697.

on AT&T's model in order to achieve its desired result. Finally, the Commission's decision to continue to "add on" the Consumer Product Dividend ("CPD") was unjustified. In 1990, the CPD was designed to pass on to consumers the "added efficiency under price caps" because it was predicted that "inflation-adjusted rate reductions [under the new price cap regime would] exceed the historical average under rate of return."[125] However, by 1997, the X-factor support data included substantial data under price caps. Therefore, there was no reasonable basis for expecting another "jump" seven years after the end of rate of return regulation. The continuation of the CPD also was inconsistent with the Commission's greater confidence that its new X-factor was an accurate assessment of LEC productivity gains. By 1997, the CPD was no longer in any way necessary to correct any inherent shortfall in the X-factor.[126]

The record is this proceeding and ILECs' recent experience under price caps further support the conclusion that the 6.5% X-factor is set too high.[127] As noted by the Economic Policy Institute in a study for the Communications Workers of America: "[t]he evidence clearly shows that productivity growth in this sector has not been fast enough to support [the 6.5%] rate of price decline . . .. Unless the industry can force large reductions in wages and benefits on its workers, the inevitable consequence will be

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125 *Policy and Rules Concerning Rates and Dominant Carriers*, 4 FCC Rcd 2873, 3001 (1989).

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

127 Bell Atlantic Comments at 11-13; Comments of Communications Workers of America at 1, 2-4 ("CWA Comments"); SWBT Comments at 24-25; Comments of U S WEST at 11-12 ("U S WEST Comments").

disinvestment in the telephone industry."[128] Indeed, the objective data available shows the industry cannot attain a 6.5% increase in productivity year after year. The comprehensive analysis submitted by USTA using the Commission's own staff model shows that actual LEC productivity gains for 1996 were an anemic 2.1% and rose only slightly to 4.1% in 1997.[129] Therefore the Commission's perceived "upward trend" cited above, to the extent it ever existed, has evaporated.[130] Ironically, the 1996 and 1997 productivity figures are both lower than the 5.2% averages rejected by the Commission as distortingly low outliers in developing the 6.5% X-factor in 1997. USTA also points out that even when recent data is combined to form four year averages, none of those averages exceed 5%.[131] On balance, recent data undermines the already weak record on the 6.5% X-factor.

The effects of competition, the steady decline in LEC employment and access rate restructuring are likely to further diminish LEC opportunities for productivity gains.[132] The advent of competition will further reduce growth in interstate access minutes and revenue, raising marketing costs and lowering productivity.[133] These competitive losses will affect output growth before services are removed from price

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128 USTA Comments at 20 (citing Dean Baker, Economic Policy Institute, "The Consequences of the FCC Price Cap Decision" Aug. 28, 1998).

129 *Id.* at 22.

130 Bell Atlantic Comments at 12.

131 USTA Comments at 23.

132 *See id.* at 27-28.

133 USTA Comments at 27; SWBT Comments at 21-23.

caps. Moreover, as Bell Atlantic observes, increased competition has slowed productivity gains by stalling revenue growth with no offsetting decrease in costs.[134] Throughout the first five years of price caps, LECs consistently reduced their employment levels by an average of 4.9%.[135] These steep reductions permitted LECs to meet their X-factor goals. In contrast, employment levels in 1996 decreased at a much slower rate (2.57%) and in 1997 actually rose slightly (0.04%).[136] Illustrative of this trend, in the first nine months of this year, GTE's employment levels have risen 5.1%. Without the efficiencies gained by sharp decreases in workforce size, the more aggressive X-factor of 6.5% will be very difficult, if not impossible, to meet. Access rate restructuring will also hinder LECs' ability to reach the 6.5% X-factor. The transition of access rates from per-minute to per-line systemically decreases productivity growth.[137] Thus, in light of the 48% efficiency gains from 1991 to 1998,[138] competition, the inability to continue to cut employment, and access rate restructuring, it will become increasingly difficult for LECs to achieve these productivity improvements year after year.

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[134] Bell Atlantic Comments at 14.

[135] USTA Reply Comments, Gollop "Sensitivity Analysis" Affidavit at 2.

[136] *Id.* at 3.

[137] USTA Comments at 27; Bell Atlantic Comments at 13; *see also* USTA Reply Comments, Gollop "Sensitivity Analysis" Affidavit.

[138] USTA Comments at 28.

Finally, the Commission should eliminate the CPD once and for all.[139] Whatever basis in the record the CPD may have had in 1990 has surely been eliminated by now. The transitional gains from a rate of return regime to price caps have been achieved and, at least according to the Commission, the accuracy of the X-factor has been improved. Certainly the Commission now has sufficient data under the price cap system to develop the most reliable X-factor possible without this add on. The clear evidence over the past two years indicates that an add on is not supportable based on carriers' actually productivity experiences.[140]

B. Contrary To MCI WorldCom's And AT&T's Claims, There Is No Basis To Depart From The FCC's Decision To Base TFP On Total Company Data.

As GTE and several other parties explained in their opening comments, the Commission should continue to rely upon total factor productivity ("TFP"), based upon "total company" data, as the basis for measuring LEC productivity for price cap purposes.[141] Modifying this approach to use "interstate only" data, as suggested by

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139 SWBT Comments at 26; USTA Comments at 29. The limited long range utility of the CPD has been recognized by Commissioner Chong. *See* Separate Statement of Commissioner Rachelle B. Chong, *Price Cap Order* ("In the future, however, a Commission may decide that competition has progressed to the stage where a CPD mechanism could be safely discarded because market forces will provide consumers with the benefit of the LECs productivity.")

140 The Commission should follow California's lead and eliminate the CPD. As California found the "simple productivity gains realized in the initial years of price cap regulation have come to an end," and the use of the CPD add-on was "no longer appropriate public policy." *Re Incentive-Based Regulatory Framer for Local Exchange Carriers*, 167 P.U.R. 4th 1 (Ca. P.U.C. 1995).

141 GTE Comments at 33-41; USTA Comments at 24-26; Bell Atlantic Comments at 14-16.

some parties, is wholly unjustified. The Commission has repeatedly rejected efforts to artificially subdivide price cap data into interstate and intrastate components.[142] 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.

Interstate-only estimates simply are inconsistent with total factor productivity methodology and theory. The price cap TFP theory is based on a complex set of factors impacting the unit cost of production designed to measure aggregate changes in efficiency. These aggregate changes in efficiency include many joint and common costs that cannot and should not be subdivided into theoretical jurisdictional pieces. As USTA points out

> [t]he 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 . . .. 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.[143]

Attempting to slice out an arbitrary subset of productivity data cannot be squared with TFP theory or be given a reasonable practical application. The practical difficulty is most clearly illustrated by the lack of any reasonable methodology for defining and delineating interstate inputs. Many other commenters joined GTE in the belief that

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142 *Price Cap Order,* 12 FCC Rcd at 16686-87; *Price Cap Performance Review,* 10 FCC Rcd at 9032-33 (citations omitted).

143 USTA Comments at 25 (quoting William E. Taylor and Charles Zarkadus, National Economic Research Associates, *Economic Evaluation of Selected Issues From the Fourth Further Notice of Proposed Rulemaking in the LEC Performance Review* at 17 (attached to USTA Comments, CC Docket No. 94-1, January 16, 1996 at Attachment C)).

"unless both input and output measurements can be meaningfully separated into interstate and intrastate components, as opposed to only output, as in the AT&T study, there can be no valid interstate-only TFP."[144] As Bell Atlantic's Dr. Melvin Fuss explains, there is no economically meaningful way to separate the total costs of producing interstate services from the costs of producing intrastate services.[145] Moreover, such divisions would only serve to further complicate an already Byzantine price cap formula at a time when increased simplicity and transparency of application have been established as regulatory goals at the Commission.

Ad Hoc suggests that developing an interstate-only X-factor is possible based on existing jurisdictional separations procedures.[146] Ad Hoc's analysis misses the mark. For outputs, Ad Hoc proposes using Exhibit D of the Access Charge Reform Order to calculate an interstate only figure. It is far from "straightforward" to "simply" omit "data series pertaining to the LECs' intrastate service offerings" in order to calculate interstate output.[147] Ad Hoc also seems to assume, in GTE's view incorrectly, that the Commission's accounting conventions correspond to meaningful economic divisions between jurisdictions.[148] Yet the Commission's separations procedures are based on arbitrary allocations of costs based on output measurements that do not reflect any

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144 GTE Comments at 36; *see also* USTA Comments at 24.

145 Bell Atlantic Comments at 14.

146 Ad Hoc Comments at 20-22.

147 *Id.* at 21.

148 See U S WEST Comments at 7-9.

valid economic analysis. However, perhaps most misguided is Ad Hoc's simplistic approach to determining LEC interstate inputs. Indeed, Ad Hoc suggests that the Commission "reasonably approximate" this figure by assuming uniform input growth for interstate and intrastate services.[149] Ad Hoc has actually argued that such an approach is "conservative."[150] In reality, USTA has shown that such an approach produces a downward biased measure of interstate input growth and upward bias in the interstate X-factor.[151] Finally, such an arbitrary division is unsupported by any record evidence or even common sense.[152] Thus the record continues to lack any defensible method of determining interstate inputs.

Calculation difficulties also undercut AT&T's claim that purportedly high interstate rates of return show that an interstate only X-factor is appropriate.[153] Any calculation of interstate rates of return is inherently flawed and misleading without a meaningful corresponding allocation of LEC costs between the jurisdictions. As set out above, no such calculation of input costs has been proposed, nor is it economically feasible to

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149 Ad Hoc Comments at 21-22; *see also* MCI WorldCom Comments at 27 (growth of inputs same for both jurisdictions); AT&T Comments at 16-22.

150 Ad Hoc Comments at 22.

151 *See* USTA Reply Comments, Gollop "Interstate Only" Affidavit.

152 *See* Bell Atlantic Comments at 15-16; USTA Comments at 24-25.

153 AT&T Comments at 22-24; Comments American Petroleum Institute Comments at 9 ("API Comments"); MCI WorldCom Comments at 31-35.

develop one. In light of these factors, these purported interstate rates of return serve as no basis for the creation of an interstate X-factor.[154]

Even if such an interstate-only calculation were possible and justified, the IXCs have offered little basis for the utility of such a measure. Most commenters seem to focus more on dramatic proposals for increasing the X-factor to the highest possible rate rather than providing any theoretical basis for a switch to interstate-only data.[155] Indeed, some commenters were rather up front in their predispositions, urging that the Commission "favor consumer interests by erring on the high side" in calculating an X-factor.[156] Such a results-oriented approach is inconsistent with the Commission's goal of developing the most reliable X-factor possible. Commenters, nonetheless, urge that a shift to interstate-only data purportedly is appropriate in light of growth in interstate volume,[157] the declining cost of capital,[158] the less labor intensive and more

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154 LEC rates of return should be virtually irrelevant to the price cap scheme. Indeed the entire purpose of price caps is not to limit LEC rate of return to the traditional level, but rather to give profit incentives to carriers to drive down rates (by a whopping 48% decrease since 1991). The fact that these profit incentives have worked does not form a basis for altering the Commission's approach to calculating the X-factor. *See* U S WEST Comments at 6-7.

155 Ad Hoc Comments at 24 (proposing X-factor of between 9.5 and 10.5%); AT&T Comments at 22 (proposing X-factor of between 9.2 and 10%).

156 API Comments at 11.

157 AT&T's Comments at 17.

158 MCI WorldCom Comments at 31-33.

technologically-driven nature of interstate services,[159] and some carriers' position that intrastate data should be used to set state price caps.[160]

The Commission has specifically rejected the argument that growth in interstate volume is *per se* evidence of interstate efficiency gains.[161] In doing so, the Commission explained that, "[i]n light of the fact that 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."[162] The record provides no support for altering this conclusion.

MCI WorldCom's cost of capital argument is premature because the Commission is currently examining the appropriate rate of return in a parallel proceeding.[163] In addition, MCI WorldCom's analysis fails to recognize that ILEC cost of equity is higher than when the rate of return was last set in 1990 due to significantly greater risks. Finally, a rigorous risk premium analysis would conclude that MCI WorldCom's estimated cost of capital rate of 9.1% is far too low.

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159 Ad Hoc Comments at 13.

160 *Id.* at 15-20.

161 *Price Cap Performance Review*, 10 FCC Rcd at 9032-33.

162 *Price Cap Performance Review,* 10 FCC Rcd at 9033 n.309; *see also Price Cap Order,* 12 FCC Rcd at 16686.

163 MCI WorldCom Comments at 31; *see Prescribing the Authorized Unitary Rate of Return for Interstate Services of Local Exchange Carriers,* CC Docket No. 98-166, Notice Initiating A Prescription Proceeding and Notice of Proposed Rulemaking (rel. October 5, 1998).

At least one commenter attempts to support an interstate-only analysis based on its bare assertions that variations in labor costs and sensitivity to technological advancements mean that an interstate-only productivity factor would be substantially higher than the company-wide figure.[164] This argument is overly simplistic and no data is provided to back it up.[165] As set out above, interstate and intrastate services inherently have significant joint and common costs. These joint and common costs cannot be simplistically segmented as posited by Ad Hoc. For example, switching costs and common trunk groups, although they can be allocated for accounting purposes, cannot be meaningfully divided in an economically rational way between jurisdictions. Instead, all of these costs are blended so that gains or losses are spread across all jurisdictional categories making meaningful jurisdictional input differentiation impossible.

Finally, Ad Hoc points to a number of state proceedings in which local carriers have purportedly argued for a productivity offset based solely on intrastate data.[166] Ad Hoc's description of GTE's efforts in California is misleading.[167] While GTE did advocate revising the California price cap methodology, GTE did not advocate an X-factor based on intrastate-only data. Nor did GTE "game the interstate-intrastate jurisdictional system."[168] GTE's state and federal price cap positions have been fully

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164 *See* Ad Hoc Comments at 13-14.

165 *Id.*

166 *Id.* at 15-20.

167 *Id.* at 20.

168 *Id.*

consistent with one another.[169] Thus, these assertions form no basis for implementing an interstate-only X-factor calculation.[170]

C. The Proposal To Reinitialize PCIs Back To 1995 Would Be Unlawful And Bad Policy.

The Commission should reject as unlawful and unwarranted some IXCs' proposals to reinitialize price caps back to 1995.[171] The proposals range from a single 6.5% X-factor adjustment for 1995 to a reinitialization proposal that would alter all of the caps back to 1995 at an X-factor of 9.2%.[172] These proposals are contrary to law and sound public policy.

In the *Price Cap Order*, the Commission concluded that a one year reinitialization was appropriate in order to balance the interests of stockholders and ratepayers. The Commission was particularly concerned about "limit[ing] [the] harm to LEC productivity incentives that could result from the perception that our regulatory policies

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169 GTE and the California Commission pointed to declines in intraLATA toll revenues as evidence of competition. GTE did not use this data in support of an intrastate-only X-factor. GTE's advocacy certainly does not amount to "gaming."

170 MCI WorldCom points to a 28% increase in depreciation and a 58.8% increase in marketing costs along with high ILEC earnings as evidence that the X-factor is set too low. MCI WorldCom seems to cite the marketing and depreciation figures as evidence of inefficiency. In reality these figures say nothing about the relative efficiency of a given enterprise. Indeed, MCI WorldCom's attack seems to be directed at the inclusion of these elements in the price cap index in the first instance. Such a criticism is beyond the scope of this proceeding and should not distract the Commission from the central fact that LEC productivity has fallen far short of the 6.5% X-factor.

171 *See* AT&T Comments at 24-27; MCI WorldCom Comments at 35-36.

172 *See, e.g.,* MCI WorldCom Comments at 36.

unnecessarily lack constancy."[173] Commenters have provided no basis for departing from the Commission's conclusion to reinitialize price caps at 6.5% for only one year.

Any reinitialization of price caps would be contrary to law. Reinitialization at this stage of this proceeding would satisfy the traditional measures of impermissible retroactivity; "[e]very statute, which takes away or impairs vested rights acquired under existing laws, or creates a new obligation, imposes a new duty or attaches a new disability, in respect to transactions or considerations already past, must be deemed retrospective."[174] Here the "transaction . . . already past" is the LEC's previous price cap selections *and* the subsequent 1997 price cap decision. For example, the LECs entered the 1995 "transaction" aware that their PCI election would trigger certain rights and obligations. However, the reinitialization for 1995 would "create a new obligation" by requiring LECs to eliminate the benefits of their 1995 and 1996 PCI choice and instead adhere to a mythical higher X-factor of 6.5% or even 9.2% – an X-factor options that were not even offered in 1995. The retroactive element would be exacerbated by the Commission's 1997 decision not to alter the 1995 cap. Whatever "notice" might have existed about the "interim" nature of post-1994 X-factor selections has surely expired.

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173 *Price Cap Order*, 12 FCC Rcd at 16714.

174 *Landgraf v. USI Film Products*, 511 U.S. 244, 269 (1944) (citing Story, J.). The standards for retroactive administrative rulemaking is at least as rigorous, if not more so than the legislative power to enact retroactive legislation. *See Bowen v. Georgetown University Hosp.*, 488 U.S. 204, 208 (1988); *see also id.* at 216 (Scalia, J. concurring)(finding bar to retroactive rulemaking inherently part of the Administrative Procedure Act.).

Some commenters seem to view the D.C. Circuit's *Bell Atlantic* decision as an impenetrable shield against any challenge to retroactive price cap manipulation.[175] Yet the adjustment at issue in *Bell Atlantic* was just that – an *adjustment* in application of the existing formula. In the 1997 *Price Cap Order*, the Commission ordered a wholesale change in its method of calculating the X-factor, "reinitialized" rates for the fifth time in seven years, increased the X-factor by 62.5% for some carriers, and for the *second time* ordered what it had purported to be a "*one time* adjustment[] . . . [to] accurately reflect[] the carriers' costs and productivity."[176] Now AT&T and MCI WorldCom would have the Commission go even further, create yet another new price cap formula, reinitialize rates for three more years, more than double the X-factor for some carriers, and mandate a third sweeping "one-time" adjustment; such constant tinkering is so far beyond the scope of the LECs' reasonable business expectations that it would clearly open the door to court challenges. Even if such a reinitialization were within the rule established by *Bell Atlantic*, application of a higher X-factor for these years would still be contrary to law because of its secondary retroactive impact.[177] There has been no evidence presented by the commenters that would support the Commission's reversal of its position on reinitialization.

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175 AT&T Comments at 25 (citing *Bell Atlantic v. FCC*, 79 F.3d 1195 (D.C. Cir. 1996)).

176 *See Bell Atlantic*, 79 F.3d at 1205 (emphasis added).

177 *See Bowen v. Georgetown Univ. Hospital,* 488 U.S. at 220 (Scalia, J. concurring) (even a rule that is not primarily retroactive may manifest "secondary retroactivity . . . [and] may for that reason be 'arbitrary' or 'capricious' and thus invalid." (internal citations omitted)).

AT&T and MCI WorldCom both support this vast reinitialization based, in part, on the notion that LECs were on notice that the 1995 and 1996 rates were interim and should therefore not be surprised by a further reinitialization to prevent understated productivity from becoming permanently ingrained in the price cap indices.[178] This precise rationale was used by the Commission to reach its one-year reinitialization decision; it provides no basis for altering this determination.

It is simply not accurate to describe the LECs as on "notice" that the 1995 X-factor might be reinitialized. While it is true that the 1995 and 1996 rates were labeled "interim," that designation applied largely to the X-factor level itself going forward rather than any concept of reinitialization. Moreover, there was no indication in the Commission's 1997 *Price Cap Order* that the new rates would be "interim" or in any way subject to constant revision. Thus, significant disruption of regulatory and investor expectations would result from any effort to once again reach back and reinitialize rates. The impact of such a change is particularly significant, for carriers such as GTE California that were operating under a 4% cap with sharing obligations for 1995 and 1996. This differential impact on 4% carriers would require a greater than 15% one-year price cap reduction by these carriers in order to meet reinitiation targets for next year. Finally, AT&T and MCI WorldCom seem most intent on arguing that LEC profits exceed some traditional rate of return figure.[179] Although GTE disputes that its earnings are excessive, it is most important for the Commission to affirm that this is not

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178 AT&T Comments at 24-27; MCI WorldCom Comments at 35-36.

179 GTE also notes that it still far from clear that IXCs pass along any significant portion of price cap reductions to consumers in the first place.

rate-of-return regulation. Price cap regulation is designed to give carriers a profit incentive like that in the free market.[180] Surely price caps' success, demonstrated through substantial productivity gains, cannot form a basis for its demise through continual efforts to achieve rate of return goals by reinitializing price caps. Efforts to straddle the two regulatory approaches only undermine price caps and lengthen the road to full competition.

The theory and practice of price cap regulation cannot support another reinitialization of caps to some higher figure. Every indication is that the X-factor was already set too high.[181] Equally important, price caps are an incentive-based regulatory regime that thrives to shape *future* LEC conduct. If the incentive is removed or continually tampered with so as to become unpredictable, the entire regulatory structure is undermined and resulting efficiency gains are threatened.

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180 GTE also notes that, for most of the years at issue, GTE remained subject to sharing obligations.

181 USTA Comments at 26.

VI. CONCLUSION

As set forth herein, the Commission should expeditiously implement a truly market-based approach to access charge reform, rather than abandon market principles in the form of drastic prescriptive measures as suggested by MCI WorldCom and others. To this end, GTE urges the Commission to: (1) remove implicit universal service support subsidies from access charges and replace them on a dollar-for-dollar basis with explicit mechanisms; and (2) implement substantial pricing flexibility along the lines advocated by USTA, particularly measures that will produce prices more closely aligned with costs. GTE's proposed plan is not only consistent with the Commission's obligation under Section 254 of the Act, but also is sound as an economic and policy matter.

Respectfully submitted,

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November 9, 1998