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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	)	CC Docket No. 94-1
Local Exchange Carriers	)	
	)	
MCI Telecommunications Corporation	)	CC Docket No. 97-250
Emergency Petition for Prescription of	)	
Access Charges	)	
	)	
Consumer Federation of America	)	RM 9210
Petition for Rulemaking	)	

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COMMENTS OF SOUTHWESTERN BELL TELEPHONE COMPANY,  
PACIFIC BELL AND NEVADA BELL

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## SUMMARY

By any yardstick, and especially by use of the measurement tools previously used by the Commission itself, competition for the ILECs' access services has grown, and ILECs therefore do not possess the market power to warrant the strict regulations to which they are now subject. This finding requires: 1) changes in the level, and application of, the x-factor; 2) increased pricing flexibility for price cap LECs; and 3) rejection of the MCI and CFA petitions.

The Commission has previously examined supply and demand elasticity, as well as market share, cost structure, size and resources, to determine the competitive nature of a market. All of these factors show active competition in the LECs' access markets. While some elements of these markets are more competitive than others, it is clear that the regulation of the ILECs currently in force (regulation that has not been significantly changed - except to impose additional burdens - since 1990) is inappropriate. Changes are warranted now.

Competition has already made serious impacts to the productivity that can be realized by the price cap LECs. USTA's updated Total Factor Productivity Review Plan (TFPRP) and the Commission's own productivity model, show the most recent five year average of annual productivity gains for the Price Cap years, 1993-1997, to be only 3.0% and 4.4% respectively. Thus, changes to the level of the factor should be made immediately. Further, as competition is more substantial in certain markets, further relaxation of the factor in those markets is justified. The USTA pricing flexibility proposal provides a framework for applying lower x-factors when specified levels of competition are shown.

The other relief proposed in the USTA pricing flexibility plan corresponds with measurable indicators of competition in the LECs' access markets. The relief described is the

minimum that should be granted, since any restrictions on competitors in access markets injure consumer welfare.

Lastly, the prescriptive adjustments requested by CFA and MCI must be rejected. These adjustments are inconsistent with the current state of competition in access markets. Further, it is much too soon to reverse the market based approach to access reform that the Commission has begun implementing. Any claims, such as those made by MCI and CFA, that the Commission's market based reforms are insufficient, are premature.

To the extent that the Commission wishes to identify a methodology to reduce access rates, it should begin by removing implicit subsidies, as suggested by SBC and USTA in the universal service proceeding, and only at that point review whether the market based approach is working properly.

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**COMMENTS OF  
SOUTHWESTERN BELL TELEPHONE COMPANY,  
PACIFIC BELL, AND NEVADA BELL**

Pursuant to the Public Notice released October 5, 1998<sup>1</sup> by the Federal Communications Commission (Commission), SBC Communications Inc., on behalf of Southwestern Bell Telephone Company (SWBT), Pacific Bell, and Nevada Bell (collectively, the SBC Companies) respectfully submits these comments on the issues listed in the Public Notice. SBC respectfully requests that the Commission promptly adopt the pricing flexibility proposal proposed by USTA, reduce the x-factor to reflect the most recent data, and deny the CFA and MCI Petitions.

While the SBC Companies have filed a petition for review of the 1997 Price Cap

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<sup>1</sup> 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, CC Docket Nos. 96-262, 94-1, and 97-250; RM-9210, (FCC 98-256) (released October 5, 1998).

Order,<sup>2</sup> and specifically challenge the Commission's imposition of the 6.5% productivity factor, the SBC Companies note here that under current facts, it is unreasonable to apply a 6.5% factor to the SBC Companies' price cap indices. These comments should not be construed as any concession or waiver of any position taken or to be taken by the SBC Companies in their appeal.

**I. THE COMMISSION SHOULD NOW CONCLUDE, BASED UPON THE CRITERIA IT HAS USED IN THE PAST, THAT ACCESS MARKETS ARE NOW COMPETITIVE.**

The Commission has previously initiated regulatory reforms (e.g., determining whether dominant carrier status is warranted, extending pricing flexibility and streamlining tariff filing requirements, among other changes) based on analyses of the likelihood that a regulated carrier either possesses, or can maintain, market power. While investigating the competitive conditions in a telecommunications market, the Commission recognized that the overall costs of prolonging stringent regulation of a firm that "has only limited market power ... and fleeting market power at that,"<sup>3</sup> can exceed the benefits, if any, to consumers. Thus, failure to recognize the erosion of any perceived LEC market power in carrier access markets delays consumers' enjoyment of the full benefits of competition.

It is time for the Commission to demonstrate its faith in the marketplace (instead of maintaining its rigid regulatory oversight) by introducing pricing flexibility into the interstate access marketplace. As Commissioner Powell recently observed: "Almost by definition, you

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<sup>2</sup>Price Cap Performance Review for Local Exchange Carriers; Access Charge Reform, CC Docket Nos. 94-1, 96-262, Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262, (FCC No. 97-159) (released May 21, 1997) (1997 Price Cap Order).

cannot predict what outcomes a healthy market will produce, and attempting to do so too broadly will result in speculation about benefits and harms that can paralyze our ability to let go of regulation.”<sup>4</sup>

The Commission has generally determined the extent, if any, to which a firm possesses market power by focusing on supply and demand elasticities, market share data, and measures of the firm's relative cost structure (including the firm's relative size and resources).<sup>5</sup> Beyond recognizing current competitive conditions in carrier access markets, however, the Commission also should note recent changes in industry structure (i.e., the pattern of corporate acquisitions and mergers) that inevitably will intensify competition in the provision of carrier access services.

**A. Supply And Demand Elasticities Show Access Markets To Be Competitive.**

Assessing competition in carrier access markets requires investigating specific aspects of the supply and demand conditions in those markets. In general, the higher the price elasticity of demand for a LEC's access services, the lower the likelihood the LEC can exercise market power. Similarly, the higher the industry elasticity of supply, the less likely any supplier can unilaterally raise (and maintain) prices above competitive levels, or even substantially above rival suppliers'

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<sup>3</sup> Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier, Order, (released October 23, 1995) at ¶ 29, citing the Further Notice of Proposed Rulemaking in the Competitive Carrier proceeding, 84 FCC 2d at 498.

<sup>4</sup> Remarks by Commissioner Michael K. Powell to PCS '98 in Orlando, FL on September 23, 1998.

<sup>5</sup> These were the primary issues investigated by the Commission in determining that the business segment of the long distance market was sufficiently competitive to warrant regulatory reforms. Competition in the Interstate Interexchange Marketplace, CC Docket No. 90-132, Report and Order, (released September 16, 1991) at ¶¶ 37-61. Later, the Commission used these same factors to determine that AT&T lacked market power in the interstate, domestic,

prices for similar services.<sup>6</sup>

### **1. Supply Elasticity.**

The presence of alternative network facilities in nearly every major metropolitan area in the nation evidences the elasticity of supply in carrier access markets. Competition does not develop uniformly across all geographic markets and customer segments. Those market (and customer) segments exhibiting more attractive profit potential will be the initial focus of competitive entry. With the deployment of alternative fiber optic network facilities in the most lucrative access market segments, competitors effectively limit, if not eliminate, any perceived ability of LECs to substantially increase access service prices in these important market segments.

The deployment of fiber optic facilities by ILEC competitors has changed the structure of access services. These networks are readily deployed for special access service, and in addition, they are used to provide the direct transport elements of switched access service. This distorts the distinction between switched access services and special access services resulting in

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interexchange long distance market. Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier, Order, (released October 23, 1995) at ¶ 38.

<sup>6</sup> Characteristics typically associated with a relatively price elastic demand for a particular supplier's services include customers' perception that alternative suppliers' services are close substitutes, the expectation that customers will readily switch from one supplier to another to gain a price advantage, and customers can easily obtain the price information necessary for their purchase decisions. Conditions contributing to a relatively high supply elasticity include the availability of sufficient alternative network capacity, the ability of rival suppliers to obtain additional capacity, and opportunities for new suppliers to enter the market. Market power is limited or absent if the anticipated response to a LEC's unilateral attempt to substantially increase its carrier access prices is a reduction in sales sufficient to make such potentially large price increases unprofitable (i.e., demand is price elastic), with rival suppliers having sufficient capacity to accommodate the shift in demand away from the LEC (i.e., supply is elastic).

competition for services based on transport (special access and the direct and common transport portions of switched access) and switched access (local switching and local loop).

The feasibility of extending competitive network facilities throughout (and beyond) metropolitan areas is enhanced by the presence of the backbone networks already deployed in nearly every major U.S. city. Such network expansion projects become increasingly more likely as the firms owning these initial backbone networks are acquired by IXCs, the primary purchasers of LEC access services. Owning these facilities clearly alters IXCs' preferences among access suppliers. Indeed, the obvious opportunity and intent to vertically integrate IXCs' long distance and newly acquired local exchange network facilities must be considered in any evaluation of the supply elasticity in carrier access markets.

In addition to presently available alternative network capacity and the increased feasibility of IXCs' expanding such capacity, pro-competitive regulatory and legislative initiatives intended to increase the attractiveness of entry provide additional constraints on the presumed ability of LECs to substantially raise carrier access prices without consequence. Readily available access to LEC network capacity (by purchasing UNEs), current resale provisions, the availability of alternative network capacity in LECs' most profitable market segments, and acquisition of most of this alternative network capacity by the largest purchasers of carrier access services (i.e., the major IXCs) combine to create competitive supply conditions which effectively limit (if not eliminate) any market power LECs are presumed to have in providing carrier access services. Additional evidence of a relatively high supply elasticity in SBC Company access service markets, as indicated by numerous competitors owning networks

and supplying access services in major metropolitan markets, and the increasing number of competitive suppliers is presented and discussed in subsection C, infra.

## **2. Demand Elasticity.**

In determining that the demand for a service is price elastic, the Commission has previously examined large business customers' willingness to request proposals from several alternative suppliers, evidence that businesses tend to be sophisticated and knowledgeable customers relying on telecommunications consultants and/or in-house experts, and an indication that businesses frequently prefer dividing their telecommunications purchases among several alternative suppliers.<sup>7</sup> The Commission has also considered alternative suppliers' offers of specialized pricing plans appealing to specific customer groups as an indicator of a relatively elastic demand for a service.<sup>8</sup> All of these indicators can be found in the current access services markets.<sup>9</sup>

Significant portions of the demand for LEC access services comes from the same large business customers the Commission previously recognized as exhibiting a relatively high price elasticity of demand for telecommunications services and other telecommunications suppliers, primarily IXCs. Large business customers are as discerning and sophisticated in choosing among alternative suppliers of access to various IXCs' networks as they are in determining which IXCs' long distance services to access. If the demand for long distance in the large business market segment is price elastic, there is no compelling reason to expect these same customers to ignore available alternatives in the carrier access market, relying upon a single supplier for

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<sup>7</sup> Competition in the Interstate Interexchange Marketplace, Report and Order, at ¶¶ 38-40.

<sup>8</sup> Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier, Order, at ¶ 64.

<sup>9</sup> See subsections C and D, infra.

accessing all their long distance services regardless of the perceived advantages of diversity and relative price differences.

IXCs are likely, in general, to be even more sophisticated purchasers of LEC access services than large business customers. As such, IXCs can be expected to take full advantage of any opportunity to reduce their payments to LECs for carrier access services. IXCs would likely be responsive to significant increases in LEC access service prices. IXCs should be expected to take maximum advantage of all existing alternatives and perhaps create new ones (such as vertically integrating their own networks) in response to increases in carrier access prices.

Beyond these qualitative indications that the demand for LEC carrier access services is relatively price elastic, additional evidence that potential SBC Company customers (both large businesses and IXCs) routinely solicit proposals from alternative suppliers, view alternative suppliers' services as comparable to LECs', and purchase alternative suppliers' services is presented and discussed in subsection D, infra.

**B. Other Criteria Show Access Markets To Be Competitive.**

Beyond supply and demand elasticities, the Commission has also identified the incumbent firms' market share, cost structure, size, and resources as factors influencing the competitive nature of a market.<sup>10</sup> In assessing market share data, the Commission recognizes that "it is well-established that market share, by itself, is not the sole determining factor of whether a firm possesses market power."<sup>11</sup>

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<sup>10</sup> Competition in the Interstate Interexchange Marketplace, Report and Order, at ¶¶ 50-61; Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier, Order, at ¶¶ 67-73.

<sup>11</sup> Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier, Order, at ¶ 68.

While a relatively small market share can be construed as strongly indicating a firm lacks market power, what might appear as a relatively large market share does not necessarily indicate a firm possesses market power. This is particularly relevant in reviewing access market data that might indicate relatively large LEC market shares, particularly in the switched access market segment.<sup>12</sup>

The entry of the major IXCs (via the acquisition of networks already deployed in the nation's largest access market segments) increases the likelihood of drawing misleading conclusions from current switched access market share data. IXCs are expected to maximize the opportunities arising from their recently acquired network facilities. If switched access payments to LECs represent a significant cost to the major IXCs, they can be expected to seek innovative applications of their local exchange network capacity to reduce as far as possible these costs. To the extent the major IXCs successfully integrate these newly acquired network facilities into their production processes, carrier access market share data (including switched access market shares) can change quickly,<sup>13</sup> and LEC market shares can decline substantially.

Considering the current pace of competitive entry in local exchange markets and recent significant shifts in telecommunications industry structure (due to IXCs' acquiring local exchange network capacity with associated customer bases), reliance on current carrier access market share data is likely misleading.

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<sup>12</sup> Placing too much emphasis on market share data can produce little more than an exercise in manipulating statistics. Policy decisions predicated on the results of "evidence" such as concentration ratios risks unnecessarily delaying vigorous price competition in telecommunications markets.

<sup>13</sup> For example, switched access market shares potentially can be effected dramatically by the development of new technologies, innovative network configurations that concentrate

With the major IXCs entering local exchange and access service markets, the size and financial resources available to LECs do not necessarily provide potential sources for alleged competitive advantages. The amount of investment capital available to IXCs and other telecommunications firms for network enhancement and/or expansion should not be expected to shrink radically as a result of their competing against LECs. Further, the significance of any LEC economies of scale and scope allegedly providing competitive advantages is substantially weakened with the appearance of major IXCs and other large telecommunications providers as competitors in access markets.

Finally, LEC cost structures cannot be argued to provide "unfair" competitive advantages since LEC competitors (i.e., the major IXCs) frequently and consistently allege LECs inefficiently deploy and operate local network facilities. If, as they implicitly claim, LEC competitors can produce significantly more efficient local networks than existing LEC arrangements, competition in access markets will quickly intensify as these more "efficient" entrants prosper at the expense of the so-called "inefficient" LECs.<sup>14</sup>

The evidence of relatively elastic demand and supply conditions in SBC Company carrier access markets, current modest SBC Company market shares in special access markets, the likely inevitable decline in SBC Company switched access market shares, the absence of evidence that SBC Company competitors are either poorly financed or inefficiently operated, clearly show together that the SBC Companies lack market power in the provision of carrier access services.

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switched access usage, or other applications not currently commonplace in telecommunications markets.

<sup>14</sup> The major IXCs often cite the Hatfield model as evidence of how inefficient LEC network operations are compared to the efficient model alternatives. See, for example, HAI Consulting, Inc., Hatfield Model, "Model Description," Release 5.0 (December 11, 1997).

**C. Evidence of the Number of Competitors, the Extent of Competitors' Networks, the Capacity of Competitive Networks, the Recent Increase in Entrants, and the Recent Acquisitions of CAPs by IXCs Shows Supply is Elastic.**

One need look no further than the increases in earnings of competitive access providers for proof of demand elasticity. Access customers are changing access providers and the earnings of the access providers bear this out. Further, the vast majority of SBC Company access customers have indicated they purchase access services from more than one access provider.

Barriers to entry into the local exchange market have fallen and large business customers can be easily targeted by various companies and optional services. On September 28, 1998, Communications Daily reported that MCI introduced flat-rate business service without distinctions, giving companies in most major U.S. markets access to a domestic and international network operated by a combined company. The merger added MCI's local assets and long distance infrastructure to WorldCom's existing MFS, Brooks Fiber Properties and UNET holdings. Company President Tim Price was quoted to state: "On-Net breaks down the barriers between local, long distance and global service that were erected by monopolies". Further, the Commission must also weigh the existence of newly merged entities like AT&T and TCG, and must also consider the impact of AT&T's potential use of TCI's facilities.

As the Chairman of the Commission has stated this year:

Most importantly, let's not lose sight of the fact that competition is emerging. We're seeing phone companies retool and redesign their networks to deliver sufficient broadband capability to meet the needs of the digital marketplace. At the same time, cable companies are doing much the same in a race to see which industry can deliver an affordable product to the market. There really was a vision underlying the Telecommunications Act. And we're beginning to see it materialize.

We see growing competition in the hundreds of state-approved interconnection agreements between incumbents and competitive local exchange carriers ("CLECS") entering the local telephone market. As of April 1998, the top 10 CLECS had switches in 132 cities spanning 33 states and the District of Columbia. Approximately 2400 interconnection agreements had been created under the 1996 Act's framework. And over the past two years, \$14 billion has been invested in CLECS, and their combined market capitalization has risen to over \$20 billion.<sup>15</sup>

Thus, customers have a growing source of supply alternatives throughout the nation. In the SBC Company states in particular, the following competitors have identified, although this is not intended to be a complete list:

STATE	CLEC NAME
AR	ACSI
	Alltel Communications Inc.
	Connect Communications
	Entergy /Hyperion
	MCI/Worldcom/Brooks
CA	Cox
	ICG
	Pac-West
	MCI/WorldCom/ Brooks/ MFS
	NextLink
	Spectranet/FirstWorld
	Winstar
	ATT/TCG
	Electric Lightwave
	Covad
	Media One
	Time Warner
	Northpoint/FirstMile
GST Lightwave	
KS	ACSI
	Digital Teleport, Inc.

<sup>15</sup> Chairman William E. Kennard, Statement Before The Subcommittee On Communications, Committee On Commerce, Science, And Transportation, United States Senate, On The Reauthorization Of The Federal Communications Commission, June 10, 1998.

	KMC Telecom
	MCI/Worldcom/Brooks
	Winstar
MO	ACSI
	AT&T/TCG
	Birch Telcom Inc
	Digital Teleport, Inc.
	ICG
	Intermedia Communications Inc.
	MCI METRO/Worldcom/Brooks/MFS
	Northpoint Communications
	Winstar
NV	MCI/Worldcom/Brooks
OK	ACSI
	Cox Communications Inc.
	Dobson Wireless, Inc.
	ICG
	MCI/Worldcom/Brooks
TX	ACSI
	Allegiance Telecom Of Texas, Inc.
	American Telco, Inc.
	AT&T/TCG
	Austin Bestline Company
	Coserv
	CSW/ICG Choice Com, L.P.
	Dobson
	Fiberwave
	Great West
	Gst Telecom
	Golden Harbor
	Intermedia Communications Inc.
	Kingsgate Telephone Inc.
	KMC Telecom Inc
	MCIMETRO/Worldcom/Mfs /Brooks
	Nextlink Communications
	Northpoint Communications
	Optel Texas Telecom Inc.
	Taylor Communications Group, Inc.
	Teligent, Inc
	Time Warner
	Us Long Distance, Inc.
	Waller Creek
	Winstar

Many, if not most of these competitors have local switches in addition to the transport facilities that they have built. These competitors have grown immensely since the beginning of price cap

regulation, and show the elasticity of supply. Price cap regulation, and the regulation of ILECs in general, must keep pace.

**D. Competitive Evidence of Customers Willing to Switch Access Providers Shows Demand is Elastic.**

The Chairman of the Commission has also noted:

We also see competition for high volume customers. Twenty percent of the local business market is being served by carriers other than the incumbent Bell Company. We see competition in the investment going into cable modems and the restructuring of the high speed data segment of the cable industry.<sup>16</sup>

This statement recognizes the acceptance by access customers of the alternatives that are now available to them. SWBT has also noted in previous tariff proceedings that customers actively seek out these alternative suppliers. In CC Docket Nos. 95-140 and 97-158, SWBT provided incontrovertible evidence that access customers had sought RFPs (Requests for Proposals) on access services they intended to purchase. Customers like MCI, AT&T, and Coastal Communications have made it quite plain that they are willing to purchase competitive services. Thus, demand is clearly elastic for these (and other) customers.

**II. FAILURE TO GRANT LECS PRICING FLEXIBILITY WILL DELAY THE BENEFITS OF COMPETITION.**

The evidence that LECs lack market power in the provision of access services mandates the extension of pricing flexibility to ILECs. Extending pricing flexibility to LECs will

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<sup>16</sup> Chairman William E. Kennard, Statement Before The Subcommittee On Communications, Committee On Commerce, Science, And Transportation, United States Senate, On The Reauthorization Of The Federal Communications Commission, June 10, 1998.

accelerate delivery of the consumer benefits expected from vigorous price competition.<sup>17</sup>

Continuing to deny LECs increased pricing flexibility prolongs the exclusion of this group of suppliers from the competitive process.

Commissioner Furchtgott-Roth has called upon the Commission to extend pricing flexibility to the LECs, saying,

The Commission's resources would be better spent pursuing the subsequent phases alluded to in our earlier proceeding that would afford additional pricing flexibility to these carriers . . .

Moreover, the amount of detailed information and regulatory scrutiny required under our current price cap rules is inordinate and should be reduced. This seemingly anachronistic regulatory regime should be reformed to provide further pricing flexibility, eliminating altogether such relics as the low-end adjustment. I continue to await anxiously the opportunity to address more fully these issues and the circumstances under which dominant LECs should be accorded a simpler form of price cap regulation.

I am becoming increasingly convinced that the current regulatory mechanisms -- and certainly the level of detail -- are no longer necessary in today's increasingly competitive environment. We must develop a more forward-looking blueprint to guide the transition from regulation to competition. As I have stated previously, regulation is merely designed, to the extent possible, to replicate a competitive marketplace, but any form of regulation is an imperfect surrogate for full-fledged competition.<sup>18</sup>

Competition ensures market prices reflect the cost structures of the most efficient suppliers. If LECs are relatively efficient suppliers of access services (despite IXCs' allegations to the contrary), precluding these suppliers from fully participating in the competitive process prevents market prices from declining to competitive levels (i.e., levels reflecting LEC cost structures). If LECs are inefficient service providers as IXCs allege, increased LEC pricing

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<sup>17</sup> The more strongly competitive retail long distance markets, the more likely access price reductions will be fully reflected in retail toll price decreases.

<sup>18</sup> Dissenting Statement of Commissioner Furchtgott-Roth in CC Docket 98-166, released

flexibility will not harm either consumers or competition. If the allegations of LEC inefficiency are accurate, LEC prices must fall to reflect those of their more efficient rivals to prevent substantial competitive losses. Inefficient suppliers cannot sustain financial losses indefinitely; either they become more efficient or exit the market. Regardless of LECs' prospects for success in a competitive market, preventing LEC pricing flexibility denies lower prices to LECs' customers and potentially denies lower market prices overall.

Commissioner Powell has suggested that the Commission should rely on strong enforcement, rather than be paralyzed by hypothetical fears, saying,

Rather than imagining all the dangers that might result if we let a company do what it has asked and then take equally speculative action to meet those speculative dangers, let's instead police conduct and make decisions based on real facts. If there are "teeth" in our enforcement efforts, companies will take heed or pay the price.<sup>19</sup>

The proposal being presented today by USTA would provide pricing flexibility as discussed by Commissioner Furchtgott-Roth, and would operate based on "real facts," as suggested by Commissioner Powell.

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October 5, 1998

<sup>19</sup> "Technology and Regulatory Thinking - Albert Einstein's Warning" at Legg Mason Investor Workshop, Washington, DC, March 13, 1998

The following table summarizes the USTA proposal being presented today:

<b>Relevant Market</b>			
<b>Geographic Components</b>		<b>Service Components</b>	
MSA, contiguous MSAs, or a LATA		Transport	Switched Access
		Residence and SL Business	Multi-Line Business
<b>Phase 1</b>			
<b>Transport Competitive Trigger</b>		<b>Regulatory Flexibility for Phase 1 Services</b>	
State approved interconnection agreement or SGAT, and customers are utilizing alternative transport services		<ul style="list-style-type: none"> <li>• New services relief:               <ul style="list-style-type: none"> <li>- No public interest showing</li> <li>- No cost support</li> </ul> </li> <li>• Eliminate Part 69 codification</li> <li>• Price deaveraging</li> <li>• Expanded volume and term pricing</li> <li>• Contract pricing</li> <li>• Promotional pricing</li> </ul>	
<b>Switched Access Competitive Trigger</b>		•	
State approved interconnection agreement or SGAT, and customers are utilizing alternative switched access services		•	

<b>Phase 2</b>	
<b>Transport Competitive Trigger</b>	
<b>Regulatory Flexibility for Phase 2 Services</b>	
25% of ILEC's transport demand is addressable through collocation arrangements or alternative networks, and customers are utilizing these alternative transport services	<ul style="list-style-type: none"> <li>• "X" Factor = GDPPI and no LFAM</li> <li>• Simplified price cap basket structure</li> </ul>
<b>Switched Access Competitive Trigger</b>	
25% of ILEC's local exchange service demand (in total or by residence/SL business vs. ML business service components) is addressable through UNEs sold to competitors or through alternative facilities, and customers are utilizing these alternative switched access services	<ul style="list-style-type: none"> <li>•</li> <li>•</li> </ul>
<b>Phase 3</b>	
<b>Competitive Trigger</b>	
<b>Regulatory Flexibility for Phase 3 Services</b>	
Competitors are capable of serving at least 75% of the market as defined in Phase 2, and customers are utilizing these alternative access services	Services removed from price caps

The characteristics of interstate access markets are such that competition for these services has developed differently by geography and service type. In the access market, the Commission's decisions in the special access collocation and switched access collocation proceedings made it significantly easier for IXC's to use CAP transport facilities to reach end users' premises and to reach LEC central offices for interconnection to switching facilities. Even before the completion of these proceedings CAP's were constructing fiber networks and providing end users and IXC's with direct interconnection to each other.

Competition in the transport market developed independently of switched access competition because it did not rely upon local competition to enable it to occur. Competition in the interstate switched access market generally requires facilities based alternatives to ILEC local exchange service because end users gain their access to interstate long distance services through the provision of local exchange services.<sup>20</sup>

The access market has also developed on a geographic basis because technology and population density have made it economical for competitors to serve high density areas without needing to serve low density or high cost areas. Competitors have elected to enter geographic areas where they can take advantage of inefficient ILEC rate structures (historically produced by regulation) to offer lower priced alternatives to ILEC access services, such as access transport.

With the implementation of the Act CLECs have taken the next step in this trend by targeting business customers for the provision of their facilities based local exchange services. In many instances CLECs have initially elected to serve residence customers through resold ILEC local exchange services. The USTA pricing flexibility proposal appropriately segments the interstate access market into geographic components (Metropolitan Statistical Areas<sup>21</sup>, contiguous MSAs or a LATA) and by service components (transport or switched access service).

Transport services include special access services, dedicated switched transport (direct and tandem access) and common transport. This distinction is necessary because these services

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<sup>20</sup> Business customers have had switched dial tone alternatives even prior to the Act because IXCs often provided these customers with better prices if they sent their switched traffic via dedicated facilities directly to the IXCs. This arrangement provided IXCs with overall reduction in access costs.

<sup>21</sup> An MSA is an urban area and its surrounding communities that meet specified population criteria and have strong economic and social ties.

are provided through the facilities of competitors to IXCs and CLECs. IXCs and CLECs also provide their own transport facilities through self-provisioning arrangements.

Switched access includes common line services (loop facilities) and local switching (switching facilities) because these two interstate access services in combination with each other provide the access to long distance service. The loop and switching components are combined through the provisioning of local exchange service and it takes both to provide local exchange service. Therefore, it makes sense to observe the competitiveness of these two individual elements combined as switched access.

The first phase of the pricing flexibility plan calls for initial relief from regulation based on the level of competition in a specific geographic area such as an MSA(s) or LATA. The first competitive trigger for transport services is the existence of a state-approved interconnection agreement or Statement of Generally Available Terms (SGAT) and customers are utilizing alternative transport services.

For switched access, the first competitive trigger would be a state-approved interconnection agreement or SGAT and customers are utilizing alternative switched access services. In this phase competitors have entered the market and customers have begun to exercise their option to switch from the incumbent provider to another competitor. This trigger ensures that facilities based access transport and local exchange service alternatives are available to an open exchange market.

For the specific services in the market areas which meet the competitive triggers of Phase I, regulatory relief should be granted as follows: no public interest or cost showing for new services, elimination of Part 69 codification, price deaveraging, expanded volume and term

pricing, contract tariffs and a relaxation of the rules for offering promotional pricing.

Relief from regulation of new services is long overdue. The Commission should eliminate any rule which in any way hinders or delays the deployment of new technologies through the introduction of a new service. The current rules, which require an incumbent LEC to seek a waiver of the rules in order to introduce a service which is not included in the list of codified access charge elements and subelements, add unnecessary cost and delay to the introduction of new services and place incumbent LECs at a severe competitive disadvantage. The averaging of costs between low and high cost markets unfairly permits competitive undercutting in low-cost markets while incumbents are still required to serve high cost markets at non-compensatory rates. Deaveraging will allow the incumbent LECs to more closely align rates with the way costs are incurred. Volume and term discounts provide substantial benefits to customers and prevent inefficient investment in the network by more closely aligning customer preferences with costs. Contract-based tariffs and promotional pricing provide more choices for customers as well as improve the efficiency of investment. Where Phase I levels of competition exist through an open market and demonstrated entry, the Commission should modify its regulations to permit the consumer to receive the benefits of incumbent LECs increased pricing flexibility.

In Phase 2 of the USTA pricing flexibility plan, the competitive trigger for transport service would be a demonstration that 25 percent of an ILEC's transport demand is addressable through collocation arrangements or alternative networks, and customers are utilizing alternative transport services. For switched access services, the competitive trigger would be a demonstration that 25 percent of an ILEC's local exchange service demand (total or by customer

segment) is addressable through non-ILEC service or facilities or UNEs sold to competitors, and customers are utilizing alternative switched access services.

In Phase 2 competitors have enough capacity and positioning to serve a significant portion of the market's customer demand. Where Phase 2 levels of competition exist, ILECs would be permitted to simplify the price cap basket structure and to reduce the productivity factor for those services that have met the Phase 2 competitive trigger. The original purpose of the productivity factor was to produce prices that replicated a competitive market. The productivity factor is no longer appropriate because services that satisfy the Phase 2 criteria are experiencing a level of competition substantial enough to not warrant its application. The price cap would also not be adjusted for the inflation variable thus foregoing any automatic price increases this variable may produce. Such relief from price cap regulation as competition increases reflects the impact of competition on the ability to achieve the same productivity levels discussed previously and is consistent with the experience of AT&T in its transition to non-dominant status.

In the third phase of the USTA pricing flexibility plan, competitors are capable of serving at least 75 percent of the market as defined in Phase 2 and customers are utilizing these alternative access services. Services in the qualifying market area would be removed from price cap regulation. Phase 3 competitive levels allow market forces to protect customer interests. Price cap regulation is thus no longer necessary for these services.

**III. THE PRODUCTIVITY FACTOR SHOULD BE REDUCED SPECIFICALLY FOR SOME MARKETS, AND SHOULD BE REDUCED GENERALLY FOR ALL PRICE CAP LECS.**

**A. The Commission Should Recognize the Growth of Competition in Setting the X-Factor**

In the Price Cap Order, the Commission considered the claims of commentators that competition will affect the productivity of the price cap LECs:

Some parties contend that measured TFP will decrease under competition because incumbent LEC output will fall as new entrants successfully compete for existing customers. USTA asserts that a one percent reduction in LEC output growth will reduce LEC TFP growth by 0.3 to 0.5 percent. We are not persuaded that we should reduce our baseline productivity estimates we are using here to set an X-Factor that will apply to all incumbent price cap LECs and all their access services. We are not deciding what, if any, changes to the X-Factor we should make with the lowering of barriers to competitive entry or the development of competition.<sup>22</sup>

While the Commission did not take action to reduce the X-factor, the Commission discussed the need for adjustments to the X-factor due to competition as follows:

A number of price cap LECs suggest that we permit LECs to use a lower X-Factor once they meet certain competitive criteria. NYNEX, for instance, recommends that we do so based on the first six items listed in the "competitive checklist" identified in the Price Cap Second Further Notice. \* NYNEX contends that we should permit a LEC to use an X-Factor of 75 percent of the baseline X-Factor if it has met the checklist criteria in 75 percent of its service area, and at least one competitor is operational in the region. NYNEX would permit a LEC to use an X-Factor of 60 percent of the baseline X-Factor if there is a "competitive presence" in areas representing 40 to 50 percent of the LEC's business access lines. \*\* SNET and Ameritech make similar proposals. \*\*\* Southwestern Bell argues that a competitive checklist should be the test to determine whether to remove services from price cap regulation rather than to permit a LEC to use a lower X-Factor. \*\*\*\* We plan to address these proposals in a subsequent Order in our Access Reform proceeding, where we will set out in detail our market-based approach to access reform.

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\*NYNEX Comments at 11-12, citing Price Cap Second Further Notice, 11 FCC Rcd at 906 (para. 108). (a) Competing providers of local switched telephone service have been authorized and have become operational; (b) local loops and switches have been unbundled; (c) intrastate expanded interconnection is available through tariff or contract; (d) service provider number portability is available; (e) compensation arrangements have been established for the LEC and

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<sup>22</sup> 1997 Price Cap Order at para. 131 (footnote omitted.)

its competitors to complete telephone calls originated on the other carrier's networks; and (f) competitors have access to directory assistance, 911, and other databases.

\*\*NYNEX Comments at 11.

\*\*\*SNET Comments at 6-9; Ameritech Comments at 10-12. In addition, Pacific argues that it has already removed barriers to entry in its region, and argues that it should be permitted to choose a lower X-Factor now rather than delaying while it goes through some certification process. Pacific Comments at 8-9.

\*\*\*\* Southwestern Bell Comments at 27-28.

In particular, the Commission recognized parties' claims that special access services may require different treatment under price cap regulation:

Bell Atlantic asserts that high capacity access services are now competitive enough to remove from price cap regulation. \* . . . We sought comment on the new services test, pricing flexibility, and extending streamlined or non-dominant treatment to LECs in the Price Cap Second Further Notice and the Access Reform Notice, and we will address those issues in subsequent Orders in the Access Reform proceeding.<sup>23</sup>

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\* Bell Atlantic Comments at 17-18. Bell Atlantic also includes with its comments an affidavit of Alfred Kahn, pointing out the pernicious effects of continuing to regulate a service after it has become competitive. See Bell Atlantic Comments, Kahn Aff.

Thus, the Commission has deferred the issue of how competition affects the productivity growth of price cap services, and in particular, special access services, until, presumably, the forthcoming order in this proceeding. Unfortunately, the march of competitors has not been likewise deferred. It is clear from section I, supra., that the current productivity factor is inappropriate, and immediate action is needed.

**B. Both The Existing Record, And Current Facts, Justify Different X-Factor Treatment Today For Specific Access Markets.**

Since the record was first developed for these dockets in 1997, competition has increased.

As shown in section I, supra., competition has grown steadily. Given this evidence of

competition, and given the fact that the application of the current 6.5% X-factor to services for which substantial competition exists is unjustified, at least some services must not be subjected to the X-factor any longer. As more fully discussed in the USTA Pricing flexibility proposal being filed today, the X-factor should be made equal to GNPPI for those markets determined to have met particular competitive indicators.<sup>24</sup>

This modification of the use of the x-factor would be commensurate with the level of competition (as described by the competitive trigger) for that market. As shown by subsection C, below, however, recent data indicates that competition may also have an overall impact on the x-factor that should be recognized.

**C. Competition Has Apparently Reduced The Productivity Gains That ILECs Can Now Realize From Their Efficiency Efforts.**

As demonstrated by USTA's filing today, the Commission's and USTA's productivity models both illustrate that the X-factor is too high and must be lowered. The USTA model (TFPRP) results, based on the most recent five-year moving averages of annual productivity gains for the Price Cap year are:

<b><u>Averaging Period</u></b>	<b><u>USTA Average 'X' from Productivity Gains</u></b>
<b>1991 – 1995</b>	<b>2.7%</b>
<b>1992 – 1996</b>	<b>3.2%</b>
<b>1993 – 1997</b>	<b>3.0%</b>

Thus, USTA's TFPRP productivity evidence through 1997 clearly shows that the Commission's current 6.5% X-factor is too high and should be lowered. Perhaps more surprisingly, however, the productivity model the Commission itself developed for setting the 6.5% X-factor also shows

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<sup>23</sup> 1997 Price Cap Order at para. 188.

that the X-factor is too high. Work done by Professor Gollop, as shown in the USTA Comments, in replicating and updating the FCC X-factor model (excluding the 0.5% CPD) provides the following results:

<u>Averaging Period</u>	<u>USTA's Update of FCC Model Average 'X'</u>
1991 – 1995	5.0%
1992 – 1996	4.2%
1993 – 1997	4.4%

Therefore, the most current updates to both the USTA TFPRP model, and the Commission's X-factor model, strongly support the conclusion that the 6.5% X-factor must be lowered.

The view of the 1997 Price Cap Order that the 1995 results were in the upper range of reasonableness to justify a 6.5% factor plainly have not materialized.<sup>25</sup> In fact, future opportunities for achieving such a high productivity offset are greatly diminished. The SBC Companies have incurred more than \$1.1 billion in expense and capital expenditures and devoted more than 3,300 employees to implement the Act and open their local markets to competition-- including but not limited to operational support systems, number portability, trunking, local service centers, equipment, computer hardware, software and manpower. Additionally, three thousand hours a day and \$1.5 million a week are being invested in preparation of Year 2000.

**D. The CPD Should Finally Be Eliminated.**

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<sup>24</sup> See Section II.A. supra.

<sup>25</sup> Because the averages listed above tend to show that the incumbent price cap LECs have fairly consistently achieved productivity growth near or at the upper end of the range of reasonableness, and because there appears to be a strong upward trend in productivity growth from 1992 to 1995, we determine that the most reasonable course at this time is to set the X-Factor in the upper portion of the range, 6.0 percent.

(1997 Price Cap Order, para. 141.)

In addition to the changes in productivity described above, the consumer productivity dividend (CPD) is no longer relevant and must be eliminated. The Commission has previously acknowledged that the CPD was designed to account for the anticipated gain in productivity resulting from the transition from rate-of-return regulation. But it has been over eight years since price cap regulation was implemented, and any such "transition" should now be considered done. As has been observed:

Since the CPD remains as a component of the X-factor year after year, the Commission must believe that more efficient regulation makes possible a permanent increase in achievable annual productivity growth, not merely a one-time change in productivity. The Commission's preferred point estimate of the historical X was taken from averages of more recent periods and adjusted to account for an increasing trend at the most recent end of the period. A heavy weight in this calculation is given to short-term, recent experience. That experience is largely taken from periods under price cap regulation, and it also includes the effect on productivity growth of moving from rate of return to price cap regulation and from price cap regulation with sharing to what the Commission characterizes as "pure" price cap regulation. As no shift to a more efficient form of regulation is contemplated in the Public Notice, there is no additional productivity growth from regulatory reform to share with consumers.<sup>26</sup>

Thus, the CPD should mercifully be put to rest once and for all.

**IV. PRESCRIPTIVE REDUCTIONS TO LEC ACCESS RATES WILL INJURE COMPETITION AND SHOULD NOT, IN ANY EVENT, BE CONSIDERED UNTIL AFTER FULL UNIVERSAL SERVICE REFORM IMPLEMENTATION.**

The Commission should stand on its judicially-affirmed refusal to implement a prescriptive approach to access reform. Nothing in the CFA or MCI Petitions provides any

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<sup>26</sup> Access Reform and Pricing Flexibility In Light Of Recent Developments In The Markets For Carrier Access Services, William E. Taylor, n/e/r/a Consulting Economics, p. 31, being filed today with USTA's comments in these proceedings.

reason to reconsider that approach. As the Access Charge Reform Order<sup>27</sup> has explained in reviewing the previous comments advocating a prescriptive method,

We reject reinitialization on the basis of rate of return at this time. As a general matter, the parties advocating a rate-of-return approach based on reinitialization do not provide any persuasive reason for adopting that particular approach. They favor reinitialization largely because they believe interstate access charges should be lower than they are now.<sup>28</sup>

Likewise, boiled down to their essence, the CFA and MCI petitions merely state their dissatisfaction with the current level of access rates. In this light, the relief requested by the petitions contradicts the pro-competitive intent of the market-based approach. As the Commission has noted:

Moreover, because the basic theory of our existing price cap regime is that the prospect of retaining higher earnings give carriers an incentive to become more efficient, we believe that rate of return-based reinitialization would have substantial pernicious effects on the efficiency objectives of our current policies.<sup>29</sup>

The Commission has specifically rejected any reason to institute a prescriptive method based on a set rate of return:

Ad Hoc's suggestion that we require a PCI reinitialization based on the currently-authorized 11.25 percent rate of return -- while administratively simpler than some other ways of changing rate levels -- would undermine productivity incentives by imposing the greatest penalties (rate reductions) on those carriers that had improved their productivity the most.<sup>30</sup>

Further, in reviewing the requests for prescriptive-based access reductions, the

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<sup>27</sup> Access Charge Reform, CC Docket No. 96-262 *et al.*, First Report and Order, 12 FCC Rcd 15982 (1997) (Access Charge Reform Order), *aff'd sub nom. Southwestern Bell Tel. Co. v. FCC*, \_\_\_ F.3d \_\_\_ (8th Cir., Aug. 19, 1998); Order on Reconsideration, 12 FCC Rcd 10119 (1997), Second Order on Reconsideration and Memorandum Opinion and Order, 12 FCC Rcd 16606 (1997).

<sup>28</sup> Access Charge Reform Order at para. 291 (emphasis added).

<sup>29</sup> Access Charge Reform Order at para. 292 (emphasis added.)

<sup>30</sup> Access Charge Reform Order at fn. 391.

Commission must consider who would actually benefit from such an approach. Since CFA filed its petition on December 9, 1997, CFA has also written a letter to Chairman Kennard. In that letter of August 13, 1998, CFA (with Consumers Union [CU]) complain that the IXCs have not generally been passing through the price cap LEC access charge reductions. CFA and CU therefore ask that future access charge reductions be applied to end user rates and not to IXC rates.

Certainly, if IXCs cannot be counted upon to pass through access charge reductions, a prescriptive remedy is at best, a tremendously inefficient way to try to reduce long distance rates. The better remedy is to allow more competitors into the long distance market, and allowing the market to drive such rates down.

**A. Any Change To A Prescriptive-Based Method Of Access Reform Cannot Be Considered, If At All, Until After Full Implementation Of Universal Service Reform.**

The proceedings reforming universal service mechanisms before the Commission is anything but simple. The interrelationship between various rates, and the implicit subsidies that remain in rates today, all create a tangled web which must only be unweaved one step at a time.

Access charges, particularly switched access rates paid by IXCs, are inflated by implicit support amounts for universal service. This fact is only apparent when one understands the interrelationship between and among rates collected by an ILEC that operates in both rural and non-rural territories.

**1. Implicit Subsidies are Identifiable in Access Charges.**

Regulators have historically capped universal service prices below the actual cost of providing universal service. Capping universal service prices creates a revenue shortfall for a

specific geographic area. For example, the federal end user common line (EUCL) charge for primary residence customers is capped at \$3.50 per month, which is well below the price level needed for revenue recovery purposes. State commissions have taken similar action with the prices for basic local service. Conversely, prices for other services were established well above their actual costs to generate the additional revenues that could be used to implicitly offset (subsidize or provide support for) this universal service revenue shortfall.

This system of implicit subsidies relies heavily upon geographic price averaging and value of service pricing principles. State regulators and the Commission have utilized these principles to accomplish their universal service goals. For example, state commissions have established vertical service prices well above the levels needed to recover universal service costs for a particular metropolitan area. This practice has the effect of recovering from customers in major metropolitan areas the cost of providing universal service to more rural areas rather than recovering these costs from customers that reside in those same rural areas.

The Commission requires EUCL charges to be averaged across a study area. This significantly reduces the EUCL charge that should be applied in many geographic areas because the per-line costs of the high demand, low cost metropolitan areas will again outweigh the corresponding costs of the low demand, high cost rural areas in the averaging process. In addition, the \$3.50 per month EUCL cap for primary residence customers further reduces the universal service charges end users should be paying.

As another example, the Commission allows interstate long distance to implicitly subsidize local service through the switched access charges IXCs pay to incumbent local exchange companies (ILECs). USTA has correctly pointed out in its recent universal service

plan that the primary interexchange carrier charge (PICC) and the carrier common line (CCL) charge represent implicit subsidy because they are recovering universal service costs from IXCs rather than from end users through the EUCL charges they pay. These two switched access charges inflate the overall price of switched access IXCs purchase. USTA has recommended that revenues from these charges be removed from switched access and recovered explicitly from a new federal universal service fund.

## **2. These Existing Implicit Universal Service Mechanisms Must Be Replaced.**

Universal service goals will be achieved only if companies are provided with the opportunity to recover their costs to provide universal service. Deciding to prescriptively reduce switched access rates (or any of the many rates that implicitly subsidize universal service) to an incremental cost level without an alternative mechanism to recover the universal service revenue shortfall would have a substantial (and possibly unintended and detrimental) effect on universal service.<sup>31</sup> As described above, the regulatory requirement to cap universal service prices creates the revenue shortfall. Non-rural LECs such as the SBC Companies must have an opportunity to offset this revenue shortfall.

Competition requires replacing many of the existing implicit universal service mechanisms with a more efficient variety, e.g., explicit mechanisms. Competition erodes the revenues generated by the existing mechanisms that are needed to offset the universal service revenue shortfall. This intuitive observation is further supported by the requirements of the Act

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<sup>31</sup> Prescribing switched access rates to incremental levels would deny non-rural LECs the opportunity to recover the universal service shortfall they incur from capping universal service prices. If faced with this dilemma, one alternative that non-rural LECs would most likely evaluate is whether to sell their high cost exchanges to rural LECs that continue to have the opportunity to recover their universal service costs. This type of public policy anomaly is

which call for support to be explicit and for all carriers providing interstate telecom services to contribute to the recovery of universal service.

The Commission should focus its resources on immediately replacing the existing implicit subsidy contained in interstate switched access charges as USTA has recommended. This simple step would produce the desired public policy outcome of reducing switched access charges with at least a chance that the IXC's would flow through to their long distance customers some portion of their switched access cost savings.

The Commission should also immediately consider deaveraging EUCL charges which would produce a direct benefit to end users that reside in metropolitan, low cost geographic areas. Rates would continue to be capped for those customers that reside in higher cost areas unless the Commission determines that the cap should change for affordability reasons at some future point in time. The universal service revenue shortfall caused by the EUCL caps should be recovered through the new federal universal service fund proposed by USTA. Only after such necessary changes to universal service cost recovery are made can any prescriptive method be examined.

**3. Even When These Implicit Subsidies Are Removed From Access Charges, Any Prescriptive Approach Is Problematic and Likely to be Unlawful.**

As detailed in the Access Charge Reform pleadings previously filed by Southwestern Bell Telephone Company, access rates have been subjected to intense scrutiny over the years:

Over the years prior to, and since divestiture, ILECS have been subject to a number of rate proceedings involving the access charge structure. These proceedings have all addressed whether the rate structure used by the ILECs (or imposed upon the ILECs) was reasonable. The reasonableness of the costs was

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questionable at best from a public interest perspective.

assumed or determined. The prudence of the investments that were included in those costs was, therefore, also assumed or determined.

Specifically, in the LEC price cap docket (CC Docket No. 87-313), the Commission addressed in detail the reasonableness of July 1, 1990 ILEC rates. The Commission detailed many of the proceedings that examined ILEC rates prior to 1990 and found that these rates were "the best that rate of return regulation can produce." The Commission explicitly rejected using a rate case to re-examine ILEC costs. These rates were based on essentially the same categories and accounts of costs as those borne by the ILECs today. Thus, the current ILEC investment should continue to be considered reasonable and prudent.

The legal issues could not be more clear. When prudently incurred costs have not been recovered, the regulatory environment must provide ILECs with a reasonable opportunity to recover these costs.<sup>32</sup>

Thus, any prescriptive approach will need to address these issues. The CFA and MCI Petitions provide no answers for these problems and present other concerns as well, as detailed below.

**B. Prescribing Lower SBC Company Access Rates Will Deter Competition.**

Any action by the Commission to prescribe lower LEC access rates is inconsistent with policy actions intended to encourage competition in telecommunications markets. Although alleged to be generating profits substantially above "normal" levels, LEC access prices apparently have not been sufficiently high enough to induce substantial capital investment in competitive network construction.

With numerous competitive access suppliers operating in the most lucrative access market segments (those areas with relatively dense concentrations of large corporate telecommunications customers), LECs clearly cannot preclude entry to protect their alleged

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<sup>32</sup> SWBT Reply Comments in Access Charge Reform, filed February 14, 1997, Section III. A., (footnote omitted).

"excess" profits.<sup>33</sup> However, widespread expansion of existing competitive network facilities or rapid acceleration of new network construction programs apparently have not arisen to eliminate claims of excessive LEC access prices and hence profits. Only recently have the major IXCs implemented programs to vertically integrate their network operations into the local exchange and access markets. IXCs' entry decisions clearly favor acquisition over construction.

If access markets are not as profitable as sometimes asserted, acquiring existing networks can present opportunities to more closely align the investment cost of entry with expected returns than would be the case if entry required network construction. IXCs will be expected to rapidly shift access services away from LECs and toward their own network facilities. If LEC access prices are significantly above competitive levels, IXCs should quickly expand their newly acquired local network capacity until LECs either substantially lower access prices or lose enough business to make exiting the market a viable alternative.

Prescribing SBC Company access rates equal to incremental cost, however, will substantially weaken incentives for further investment in local exchange network facilities. To the extent LECs' incremental costs of supplying access services (ignoring initial investment outlays and the associated risks) are expected to be significantly lower than the prospective cost of constructing additional network facilities, IXCs could minimize costs by purchasing LEC access services rather than expanding their own competitive network facilities. Such a

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<sup>33</sup> Indeed, another reason to avoid any prescriptive remedy is found in the petition for declaratory ruling filed last Friday by AT&T. (AT&T Petition For Declaratory Ruling, In the Matter of Interexchange Carrier Purchases of Switched Access Services Offered by Competitive Local Exchange Carriers, filed October 23, 1998.) AT&T's petition complains that terminating access charges of many CLECs are much higher than those of the ILEC with which they compete, and attaches a table listing the rather large price differences. These facts show that there is no basis to prescriptively reduce access rates of the ILECs.

preference for LEC access services will be strengthened to the extent IXCs can succeed in convincing regulators to prescribe LEC rates on the basis of costs computed for a hypothetical, allegedly “more efficient,” local exchange network than those currently operated by LECs.

Suggesting that the Commission prescribe LEC access rates equal to incremental costs is a recommendation for substantially weakening both LEC and IXC incentives for network investment, thereby seriously threatening the prospects for realizing rapid development of widespread facilities-based competition in local exchange and access markets. Ultimately, any consumer benefits expected to accompany facilities-based local exchange and access competition will be delayed and potentially halted (perhaps for a long time).

**C. The Relief Requested By The CFA and MCI Petitions Is Incompatible With The Development Of Competition.**

**1. CFA Petition.**

The CFA Petition’s basic premise is that there is insufficient local competition, and therefore access charges will not be reduced to competitive levels, necessitating prescriptive action.<sup>34</sup> The key question that the Commission should ask in analyzing this claim in the present proceeding is: “Are there competitive alternatives for ILEC access services that keep competitive pressure on the price of access?” The answer, as discussed above, is clearly that such competitive alternatives exist. At a minimum, cost-based UNE prices have gained at least interim approval in all SBC states. These serve as a greatly discounted substitute for the SBC Companies’ own access services.

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<sup>34</sup> CFA at p.5.

Nowhere in the Communications Act or in Commission rules does it state that the overwhelming majority of consumers must have a choice of local provider available to them by some date certain, as the CFA Petition contends on p. 5. Rather, the Act directs the ILECs to take specific steps to open their markets to potential entrants. The SBC Companies have gone to great lengths to open local markets to competitors. Wholesale prices have gained regulatory approval, and yet there still are insufficient actual competitive alternatives to satisfy the CFA Petition. The stage is set for competitors to enter; lack of entry is more likely due to CLECs' strategic reasons than pricing and systems structures.

Page 3 of the CFA Petition argues that access charges today “massively exceed the cost-based levels found appropriate by the Commission. The continued existence of these access overcharges is not surprising.” It is widely acknowledged that access prices exceed underlying economic cost. The Access Charge Reform Order concluded that “accurate forward-looking cost models are not available at the present time to determine the economic cost of providing access service.”<sup>35</sup> The Commission further concluded that “lacking the tools for making accurate prescriptions, precipitous action could lead to significant errors in the level of access charge reductions necessary to reach competitive levels. That would further impede the development of competition in the local markets and disrupt existing services”.<sup>36</sup> For the CFA Petition to describe current prices as “access overcharges” is completely subjective and it discounts the Commission’s entire history of overseeing access charges.

Strictly regulated access prices exceed costs because they are laden with cross subsidies that flow to maintain low local rates. It is not that ILECs are using them as competitive means of

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<sup>35</sup> Access Charge Reform Order at para. 45.

keeping CLECs dependent on ILEC facilities. The CFA Petition completely ignores the substantial access charge reductions that have resulted from the mandated increase of the productivity offset. These reductions totaling some \$3B over the past two years have gone a long way toward moving access charges closer to cost.

If margins on access were as obscene as the CFA Petition contends, then there would have been overwhelming (even more than the levels encountered today) competitive entry into the access market to siphon off those profits. CAPs are observed entering and displacing some portion of ILEC access traffic. Competitive markets ferret out excessive profits. If ILECs, despite keen regulatory oversight at the state and federal level, are somehow earning excessive earnings from UNEs or access services, then entrants would quickly get into those markets to share those profits, eventually driving down prices. If this doesn't happen, then three possible explanations surface: (1) There are no excessive profits for entrants to share; (2) A natural monopoly exists in local exchange meaning that it would be inefficient and diminish consumer welfare for more than one supplier to operate; and (3) Even though the financial incentive is present, strategic interests of potential entrants (i.e., keeping RBOCs out of long distance) are keeping them from actually entering. None of these explanations can justify a prescriptive access charge reduction.

Page 7 of the CFA Petition wrongly concludes that due to the 8<sup>th</sup> Circuit's decisions, "resale is the only viable means for many CLECs to compete for most customers." The CFA Petition views the 8<sup>th</sup> Circuit's decision on UNE pricing as stripping the Commission's influence over

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<sup>36</sup> Access Charge Reform Order at para. 46.

pricing—“the Commission is largely powerless to alter the state pricing decisions.”<sup>37</sup> Apparently the CFA Petition views state regulators as less-than-competent at directing wholesale prices. As with Universal Service, the Commission and state regulators have coordinated closely to ensure consistent wholesale pricing philosophies and actions. The 8<sup>th</sup> Circuit’s decision came well after many states had already adopted many of the Commission-originated pricing methods for developing wholesale prices. A review of the methods approved by the states indicates that the Commission’s influence remains secure, despite the Court’s ruling.

## **2. MCI Petition.**

Pages 4 and 5 of the MCI Petition wrongly assert that present UNE rates are not set at forward-looking economic cost and, therefore, do not allow for competitive entry. Neither the Act nor the Local Competition Order require UNE rates to be set equal to incremental cost. Rather, these sources call for cost-based (different from setting prices at cost) UNE and interconnection rates. No business enterprise, including MCI, could survive with prices set at cost. Pricing at cost precludes the recovery of legitimate shared and overhead costs that must be covered by the firm’s prices to ensure financial viability.

Page 5 of the MCI Petition claims, without support, that “UNEs are not available at forward-looking economic cost throughout the country”. In fact, all SBC Company states, at a minimum, have approved interim UNE rates that are inextricably bound to forward-looking economic cost. Contrary to MCI’s claim, cost-based UNE rates are available and have been since the release of the Access Charge Reform Order.

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<sup>37</sup> CFA at p. 8.

The Commission devised a new cost concept of TELRIC to fulfill its intent to develop cost-based wholesale rates. TELRIC is a forward-looking economic cost measure to which is added a modest allocation of forward-looking joint and common cost to arrive at wholesale prices. The MCI Petition maintains that competitive entry is somehow impossible without UNEs priced exactly at incremental cost. Further, the MCI Petition contends that cost-based UNE prices provide no downward pressure on access prices. MCI's logic is unexplained and perplexing.

Cost-based UNE prices offer a heavily discounted substitute for ILEC access services. Competitors purchasing UNEs at very near incremental cost can bypass ILEC access services completely since ILECs are precluded from assessing access charges on purchasers of UNEs. Cost-based UNE prices that substitute for ILEC access services certainly place downward pressure on access service prices. Any firm offering a service (access) for which there is a much lower-priced substitute service available (UNEs) experiences market pressure to lower the price of that service (access). The Commission describes this phenomenon accurately in its Access Charge Reform Order at paragraph 265. This phenomenon is the very essence of competition and shows why competition is beneficial to consumers in that it generally leads to lower, cost-based prices.

In speaking of current access prices, the MCI Petition nowhere mentions two important facts: (1) the higher productivity offset factor mandated in the Commission's Price Cap Review Order resulting in a very substantial and immediate reduction in access charges (the immediate effect was a reduction of some \$1.7B, with a similar reduction following this year); and (2) ILECs have very little control over the level of access charges. Paragraph 273 of the Access

Charge Reform Order states that the "access charge and price cap rules are designed to ensure that access charges remain within the 'zone of reasonableness' defining rates that are 'just and reasonable.'" Paragraph 276 further states that "price cap regulation of access prices limits the ability of LECs to raise the prices of the input services [i.e., access charges]"

As the Commission points out, regulatory oversight constrains the level of access rates, not, as the MCI Petition contends, anticompetitive ILECs. In addition, access charges have been mandated above-cost as part of the patchwork of cross-subsidies that go to keep average local residential rates low. MCI's proposal simply to prescribe access charges to forward-looking economic cost completely disregards the social policy that characterizes telecommunications pricing. In the Access Charge Reform Order (para. 260), the Commission reminds us that its market-based approach "retains the protection afforded by price cap regulation, while relaxing particular restrictions on incumbent LEC pricing as competition emerges."

In its position in the original Access Charge Reform proceeding, MCI asked that access rates be prescribed at forward-looking economic cost. The Commission (in paragraphs 45-46) expressly rejected that argument for the following reasons:

1. Accurate forward-looking cost models are not available at the present time to determine the economic cost of providing access service.
2. The Commission remained concerned that any attempt to move immediately to competitive prices for the remaining services would require dramatic cuts in access charges for some carriers. Such an action could result in a substantial decrease in revenue for ILECs, which could prove highly disruptive to business operations.
3. Lacking the tools for making accurate prescriptions, precipitous action could lead to significant errors in the level of access charge reductions necessary to reach competitive levels. That would further impede the development of competition in the local markets and disrupt existing services.

The Commission “acknowledged that a market-based approach under this scenario may take several years to drive costs to competitive levels” (para. 45). Thus, disrupting the Commission’s market-based plan after only one year of implementation is much too premature. The structure of access charges is tremendously complex and it is bound to take several years for a massive restructuring of access charges to approach the desired result of competitive access charge levels. Page 2 of the MCI Petition argues that the complete combining of UNEs by ILECs is a requirement for successful local competition (“Without a requirement that the ILECs combine network elements, the scope for UNE-based competition is sharply limited”). MCI claims that the 8<sup>th</sup> Circuit Court’s overruling of the FCC requirement for ILECs to combine UNEs undermines the viability of competition to develop by a platform approach. While MCI may be dissatisfied with the 8<sup>th</sup> Circuit’s ruling, it is clear that the FCC’s original requirement to combine UNEs was improper. The Commission should not be tempted by MCI to override the 8<sup>th</sup> Circuit’s decision by subsequent proceedings on its Access Charge Reform Order.

Page 5 of the MCI Petition complains that MCI might have to resort to investing in its own facilities in order to enter the local market. This conclusion should come as good news to the Commission and to legislators. The Act sought to promote facilities-based competition since facilities-based competition is the only means that enhances consumer welfare. Resorting to facilities investment was also a goal of the Local Competition Order.

The MCI Petition complains that facilities-based entry is “by definition, severely constrained by the time required to construct facilities or collocations and by the need for massive levels of investment” (p. 6). In the United Kingdom where UNEs and resale were not required, competitors (including SBC) of the incumbent local exchange carrier, British Telecom,

quickly built facilities and captured a significant portion of the local market in short order.

Again, if there is sufficient demand and profit to justify the investment, facilities can be built and facilities-based alternatives will develop quickly.

Page 7 of the MCI Petition claims that “the current level of interstate access charges constrains the financial resources available for IXCs to pursue a facilities-based local strategy.” MCI would apparently have the Commission believe that it does not recover the cost of access in its long distance prices. If IXCs did not recover the cost of its production inputs through its prices, then they could not remain in business. To be clear, the IXCs are passing that cost through to their customers in the form of higher long distance rates. As the price of access has fallen and continues to fall, competitive forces should drive the price of long distance down commensurately (assuming long distance is a competitive market). Since all cost savings in competitive markets are passed through to price reductions, IXCs would have no additional capital to invest in local facilities even if access charges fell to economic cost.

MCI would have the Commission believe a zero-sum game scenario: the RBOCs “continue to line their pockets with capital that long distance companies could otherwise invest in local facilities” (pp. 7-8). In other words, MCI’s claim is that ILECs’ access revenues rightly belong to IXCs. MCI assumes no other forms of capital are available to them to invest in what MCI deems a desirable business. This smacks in the face of recent IXC consolidations that are designed to gain the capital necessary to expand into local. The logical extension to MCI’s argument would be that ILECs funnel all access revenues above cost to IXCs so that IXCs could use this wealth transfer to fund their expansion plans to compete against the ILECs.

Page 8 of the MCI Petition wrongly claims that “IXCs are placed in a position where

there is no efficient cost-causative manner in which they can recover PICC charges assessed on them by the ILEC for zero-use customers.” The PICC was developed to replace the carrier common line (CCL) rate. The CCL housed the interstate portion of local loop costs (no matter the usage) that are not recovered through local rates. The cost-causative solution is to recover CCL directly from end users, even zero-use end users. The IXCs recover their PICCs just this way. Note the many IXCs that have "marked-up" the PICC to their end users.

#### IV. CONCLUSION.

For the foregoing reasons, SBC respectfully requests that the Commission promptly adopt the pricing flexibility proposal proposed by USTA, reduce the x-factor to reflect the most recent data, and deny the CFA and MCI Petitions.

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## **CERTIFICATE OF SERVICE**

I, Katie M. Turner, hereby certify that the foregoing, " COMMENTS OF SOUTHWESTERN BELL TELEPHONE COMPANY, PACIFIC BELL, AND NEVADA BELL" in CC Docket No. 96-262, CC Docket No. 94-1, CC Docket No. 97-250 & RM No. 9210 has been filed this 26<sup>th</sup> day of October, 1998 to the Parties of Record.

/s/ Katie M. Turner

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