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Before the
Federal Communications Commission
Washington, D.C. 20554

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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
	)	
Interexchange Carrier Purchases of Switched Access Services Offered by Competitive Local Exchange Carriers	)	CCB/CPD File No. 98-63

COMMENTS
OF THE
UNITED STATES TELEPHONE ASSOCIATION

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October 29, 1999

TABLE OF CONTENTS

SUMMARY i

I. INTRODUCTION AND SUMMARY. 1

II. GEOGRAPHIC DEAVERAGING FOR SWITCHED ACCESS SERVICES SHOULD BE ADOPTED WITHOUT ANY COMPETITIVE SHOWING 3

III. PHASE TWO PRICING FLEXIBILITY FOR SWITCHED SERVICES SHOULD BE CONSISTENT WITH THAT ADOPTED FOR TRANSPORT SERVICES 9

IV. THE COMMISSION'S PROPOSALS REGARDING MANDATORY LOCAL SWITCHING RATE STRUCTURE CHANGES ARE UNNECESSARY AND ILL-ADVISED 10

A. The Commission Should Not Mandate a Capacity-Based Local Switching Charge 10

B. The Commission's Proposal to Include a "q" Factor in the Traffic-Sensitive PCI Formula is Based on Incorrect Assumptions and Should Not Be Adopted . . . 15

C. The Proposal to Increase the g/2 Factor in the Common Line Formula is Flawed and Should Not Be Adopted 19

D. There is No Need for the Commission to Mandate Revisions to the Rate Structure for Tandem Switched Transport 20

E. The Price Cap Basket Structure Should Be Streamlined 20

V. THE COMMISSION'S PROPOSALS TO REGULATE CLEC TERMINATING ACCESS ARE PREMATURE AND CONFLICT WITH THE MARKET-BASED APPROACH TO ACCESS PRICING 21

VI. CONCLUSION 26

ATTACHMENT

SUMMARY

The Commission must continue to implement policies that rely on market forces rather than regulation to ensure efficient pricing, production and investment. The Commission should adopt the Phase II pricing flexibility and the deaveraging as recommended in USTA's comments. The Commission should refrain from mandating a capacity-based local switching rate structure and should not adopt the unnecessary and ill-advised changes to the price cap formula. Specifically, USTA urges the Commission to address the following points:

- Price cap regulation is working and is providing real economic benefits to consumers. Price cap regulation is not broken and does not require "fixing". Regulatory intervention is not required and would be detrimental to the preservation of the efficiency-enhancing incentives of price cap regulation.

- Deaveraging of interstate common line and traffic-sensitive access charges within study areas without a competitive showing will allow price cap LECs to better align prices with costs resulting in efficiency improvements. The benefits of deaveraging are clear: enhanced economic efficiency due to economic pricing and improved utilization of facilities. As network elements are deaveraged, deaveraging of access charges will permit optimal levels of network element and facilities-based competition.

- USTA has provided the Commission with a proposal to permit price cap LECs to deaverage the SLC which recommends the use of UNE zones and the development of a zone common line cost per line.

- Price cap LECs should be permitted to utilize zone pricing for traffic sensitive costs to accommodate geographic variations in such costs.

- Phase II pricing flexibility for switched services should be similar to that adopted by the Commission for transport services, however, in addition to the alternatives provided by the Commission for transport, price cap LECs should also be permitted to make the competitive showing based on the class of customer served. This would allow price cap carriers to respond to competitors that target large business customers when entering a new market.

- A capacity-based rate structure for local switching costs should not be mandated. The Commission's proposal is based on faulty assumptions and a faulty analysis. Local switching costs are not declining. These costs are the subject of an arbitrary allocation system that has assigned more of these costs to the intrastate jurisdiction. The dramatic increase in Internet traffic, which the Commission has arbitrarily

declared should be assigned to the intrastate jurisdiction even when it acknowledges that such traffic is primarily interstate, is one example.

- Dr. William Taylor, in the attached statement, observes that the Commission, erroneously motivated by alleged windfalls, is attempting to find a solution to a problem that does not exist. Capacity-based switching charges are, in reality, merely another form of traffic-sensitive recovery.

- Any perceived benefits to capacity-based pricing will be significantly outweighed by the substantial costs involved in implementing such a structure. The capacity-based structure will suffer the same deficiencies as peak pricing. A mandatory capacity-based structure will reduce customer choice and competitively handicap price cap LECs.

- Price cap carriers should be permitted to rely on market forces to determine the appropriate rate levels or rate relationships for switching charges.

- Volume and term discounts should be permitted in Phase I for switched access services, even under a capacity-based structure. Such discounts are normal business tools that the Commission itself acknowledges are in the public interest.

- There has been no opportunity for price cap LECs to experience a windfall due to a putative misalignment between NTS costs and usage-based prices in the traffic sensitive basket. Under either the indirect (historical cost) or direct TFP approach to calculating the X-Factor, no alleged windfall could occur.

- It is economically erroneous to conclude that an alleged windfall exists based on accounting data since regulatory accounting distorts both the level and growth of earnings and relies on the arbitrary separations process to estimate earnings at the basket (or interstate only) level. Using the more appropriate economic rates of return, no windfall exists.

- There is no evidence that price cap LECs enjoyed a windfall. Neither the level nor growth of price cap LEC earnings is out of the range observed in unregulated, competitive markets. On an empirical basis, price cap LECs did not perform as well as the average industrial firm, although price cap customers have done considerably better.

- If the Commission adopts the "q" factor, thereby assuming a slower growing output, a lower X-Factor will be required.

- The g/2 factor should not be increased because use of either the indirect or direct TFP approaches makes "g" unnecessary. Most price cap LECs have already eliminated the CCL charge, thus also making "g" unnecessary. Finally, it is incorrect to attribute all long distance growth to the IXCs since such growth is due primarily to lower access prices.

- There is no need for the Commission to apply any of the proposed changes to the rate structure for tandem-switched transport, as the same deficiencies would occur.

- The price cap basket structure should be streamlined and the number of baskets decreased as previously proposed by USTA.

- AT&T should not be permitted to unilaterally decline to terminate calls to end-users because it disapproves of the terminating rates charged by a CLEC. Such action undermines the Commission's statutory authority, renders the existing complaint procedures and Section 214 requirements meaningless, limits customer choice, creates customer confusion, reduces competition, and undermines Section 201 obligations. It could also undermine the filed rate doctrine and could result in an increase in under or unserved areas of the country.

- It would be premature for the Commission to impose rate regulation on CLECs. The Commission should rely on market solutions, not regulation, to ensure appropriate terminating access rates. AT&T and any other carrier can always challenge CLEC terminating rates through the complaint process.

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COMMENTS
OF THE
UNITED STATES TELEPHONE ASSOCIATION

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

I. INTRODUCTION AND SUMMARY.

On August 27, 1999, the Commission released its Pricing Flexibility Order adopting a specific framework under which carriers subject to price cap regulation would receive pricing flexibility in the provision of interstate access services as competition develops.[1] This framework is the first step in the implementation of the market-based approach to access reform previously adopted by the Commission.[2] In a Further Notice of Proposed Rulemaking

[1] In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Interexchange Carrier Purchases of Switched Access Services Offered by Competitive Local Exchange Carriers, Petition of U S West Communications Inc. for Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA, FCC 99-206, *Fifth Report and Order and Further Notice of Proposed Rulemaking,* CC Docket No. 96-262, CC Docket No. 94-1, CCB/CPD File No. 98-63 and CC Docket No. 98-157(rel. Aug. 27, 1999).
[2] *Access Reform First Report and Order*, 12 FCC Rcd 15985 (1997).

(FNPRM), the Commission seeks comment on additional pricing flexibility for incumbent LECs subject to price cap regulation. Specifically, the Commission seeks comment on proposals for geographic deaveraging of the rates for services in the common line and traffic-sensitive baskets and the appropriate triggers for granting Phase II relief for services in the common line and traffic-sensitive baskets, as well as for the traffic-sensitive parts of tandem-switched transport service. USTA previously has provided the Commission with specific recommendations to implement these proposals and will update its previous recommendations to ensure consistency with the Commission's pricing flexibility order.

In a complete departure from the market-based approach, however, the Commission also seeks comment on proposals to impose new regulations mandating a capacity-based rate structure for the local switching category of the traffic sensitive basket and altering the traffic-sensitive price cap index (PCI) formula. These proposals represent a return to micromanagement on a scale that is completely contrary to the market-based approach. USTA had hoped that the Commission recognized that market forces are infinitely superior to reliance on regulation to determine efficient levels of output, investment and price and that the Commission would primarily rely on them. USTA had also hoped that the Commission was pursuing policies that reward efficiency, not ones that protect particular competitors. These proposals represent a retreat to rate of return regulation which is completely unjustifiable and which should be summarily rejected. Attached to these comments is a statement prepared by Dr. William E. Taylor of the National Economic Research Associates which demonstrates that the Commission's proposals are ill advised and unnecessary. As explained by Dr. Taylor, the Commission has proposed uneconomic solutions to a problem that does not exist. Price cap

regulation is working and the tinkering with the price cap formula based on misconceptions regarding incumbent LEC earnings must stop.

Finally, the Commission seeks comment on whether it should adopt regulatory constraints on the terminating access charges of competitive local exchange carriers (CLECs). USTA opposes the adoption of such regulations.

II. GEOGRAPHIC DEAVERAGING FOR SWITCHED ACCESS SERVICES SHOULD BE ADOPTED WITHOUT ANY COMPETITIVE SHOWING.

As USTA recommended in its pricing flexibility proposal, incumbent price cap LECs should be permitted to deaverage interstate common line and traffic-sensitive access charges within study areas without a competitive showing.[3] The averaging of costs and prices as required in the Part 69 rules does not provide sufficient flexibility to allow incumbents to appropriately align rates with the manner in which the costs for services are incurred. Deaveraging access service rates by geographic area will allow carriers to move toward economic alignments resulting in efficiency improvements. Because of the economic benefits of this type of flexibility, deaveraging should occur regardless of the extent of competition in a particular study area.

Geographically averaged rates cause prices in some areas to exceed their economic costs, while prices in other areas are below costs. This type of pricing creates two types of inefficiencies: inefficient utilization of telecommunications resources and distorted competitive incentives. As explained by Richard Schmalensee and William Taylor, in high cost areas where economic costs are likely to exceed prices, distortions occur because consumers are given a false signal to add lines even though the marginal benefit to the customer may be less than the

[3] USTA Ex Parte Filing, CC Docket No. 96-262, July 13, 1999.

incremental cost incurred.[4] Competitive distortions occur due to the inability of competitors to compete with below-cost prices. In low cost areas, the opposite effect occurs. Because prices are higher than their economic costs, consumers are discouraged from adding lines even though their marginal benefit may be greater than the incremental costs incurred. Competitors are falsely encouraged to enter the market even though their incremental costs maybe higher than the incumbents'. Restricting deaveraging flexibility artificially impedes efficient competition by not accurately depicting the true economic costs incurred and increasing the likelihood of uneconomic bypass.

In addition, as network elements are deaveraged, it becomes imperative to permit deaveraging so as to provide optimal levels of network element and facilities-based competition. Preventing or delaying access service prices to be deaveraged distorts competition between UNEs and other incumbent LEC-provided services. Competitors can target low cost areas where some or all customers pay higher rates than are justified by costs, purchase UNEs in that area at a cost-based rate and undercut the incumbent's rates. Without the ability to deaverage, incumbents will be unable to respond effectively. This problem is compounded by the fact that UNEs are not priced differently for different types of end users despite the fact that the prices of the services with which they compete are different depending upon the end user. Moreover, the higher SLCs and PICCs charged to business customers, who generally have lower nontraffic sensitive costs on average, contribute to a subsidy from business to residential customers. Since UNEs are required to be deaveraged, they can easily be used to arbitrage this subsidy away.[5]

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[4] Richard Schmalensee and William Taylor, "The Need for Carrier Access Pricing Flexibility in Light of Recent Marketplace Developments: A Primer," 1996.

[5] Interconnection Between Local Exchange Carriers and Commercial Mobile Radio Service Providers, 11 FCC Rcd 15499 (August 8, 1999).

The benefits of deaveraging are clear. Deaveraging rates by geographic area enhances economic efficiency by sending improved price signals and leads to improved utilization of telecommunications facilities.[6] This is especially important in the early stages of competition because efficient entry decisions should be made on the basis of economic cost. Permitting geographic deaveraging for switched access services will serve to eliminate the asymmetric regulation which economists have fulminated against as posing greater risks for consumers through inefficient entry and pricing. Economists consistently have maintained that flexibility should be granted when markets are first open to competition. As Dr. Taylor has explained, technical economic efficiency is fostered when all firms are permitted to offer services that reflect economic cost. Some access prices today exceed what their level would be in unregulated competitive markets while others fall below the competitive level. Averaging prevents competitive forces from ever aligning prices and costs, as they would be under unregulated, competitive conditions. If incumbents are not granted such flexibility, competitors will have even greater incentives to compete only for business customers in dense areas where service costs are low relative to the incumbent LEC price and to continue to ignore residential and rural customers where costs are likely to exceed the incumbent LEC's regulated price.[7] The averaging of costs and prices encourages competitive undercutting in low-cost markets while incumbents must serve high cost markets at non-compensatory rates. Such asymmetric competition leads to welfare losses. The ability to deaverage will help to alleviate the asymmetrical restraints on the competitive responses available to incumbent LECs. Deaveraging is consistent with competitive markets and the Commission should rely on market dynamics to determine the optimal amount.

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[6] Richard Schmalensee and William E. Taylor, "Economic Aspects of Access Reform," USTA Comments, CC Docket No. 96-262, January 29, 1997 at Attachment 1.

Permitting geographic deaveraging is certainly consistent with the Commission's decision to lift the restrictions imposed on new service offerings without a competitive showing in that these are normal tools which all service providers should be permitted to utilize, particularly in markets where customers desire customized services. In order to preserve economic efficiency, and provide appropriate economic signals, deaveraging should occur regardless of the amount or degree of market forces.

USTA has already provided the Commission with a proposal to permit price cap LECs to deaverage the SLC.[8] Deaveraging of the SLC should be permitted, but not required, since the current SLC caps may prevent any meaningful deaveraging of the SLC for a number of years. In fact, the SLC caps should be raised to facilitate deaveraging. Pursuant to USTA's proposal, wire centers or exchanges within a study area would be assigned to a pricing zone. A study area would generally be divided into a minimum of three zones. The common line costs for each zone within a study area would be determined using either UNE rate relationships (loops plus ports) to allocate study area common line costs to the zones or by using actual common line costs. The Commission must avoid the creation of different zones for universal service, UNEs and SLCs to prevent uneconomic arbitrage. USTA supports the use of UNE zones as preferable to the use of trunking basket zones as the latter generally have little correlation to the way that common line costs are incurred. Further, if UNE zones were utilized, no advance approval of zones would be required. However, even if LECs were permitted to establish their own zones, minimal advance notice would be required. As explained above, the LECs seek deaveraging in

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[7] William E. Taylor, "Productivity and Pricing Flexibility: Reply Comments," USTA Reply Comments, CC Docket No. 96-262, November 9, 1998 at Attachment A.

[8] USTA Comments, In the Matter of Federal-State Joint Board on Universal Service, Access Charge Reform, CC Docket Nos. 96-45, 96-262, July 23, 1999.

order to better align their prices with costs to the greatest extent possible to allow them to compete. The market will ensure that the zones are appropriate.[9]

A zone common line cost per line would be calculated by dividing the zone costs by the number of lines in the zone. A zone/study area common line cost ratio would be calculated by dividing each zone's common line costs by the study area total. The total reimbursable common line costs would be calculated by summing the interstate SLC, PICC and CCL revenues for the study area. Total reimbursable common line costs should be allocated to each zone by applying the common line cost ratio for each zone to the study area total reimbursable common line costs. The reimbursable common line costs for a zone would be determined by summing the reimbursable costs for all wire centers assigned to the pricing zone. The deaveraged SLC for the zone would be calculated by dividing the reimbursable common line costs by the number of common lines in the zone.

While USTA's proposal is not dependent upon increases in the SLC caps, USTA supports increases in SLC caps to reduce implicit support for nonrural LECs. Ideally, the ultimate SLC caps should be set to more closely align with the interstate common line costs of the end user (including Marketing expense). If necessary, a transition period could be used to arrive at the ultimate amount. End users would pay the lower of the deaveraged SLC or the cap. If the end user's deaveraged SLC is greater than the ultimate SLC cap; the federal universal service fund would pay explicit support equal to the difference between the deaveraged SLC and the ultimate SLC cap to the eligible telecommunications carrier serving the end user.

[9] Even if these items are aligned in an economically reasonable manner, the Commission should be aware that intrastate prices will not be and the Commission should encourage the state regulatory commissions to make similar adjustments in state rate structures over time.

Deaveraging the SLC without raising the SLC cap above the current level will simply increase the size of the universal service fund.

USTA has previously recommended to the Commission that nonrural carriers recover their common line costs from the end user. USTA developed a consensus plan in 1998 for replacing the implicit universal service support derived from interstate access rates for nonrural carriers.[10] USTA recognized that although this is an important source of support for nonrural carriers, recovery through the carrier common line and presubscribed interexchange carrier charges is not sustainable in a competitive environment. Therefore, USTA proposed a mechanism whereby the common line costs would be recovered explicitly through the SLC and the universal service fund. As common line costs are recovered from the SLC, deaveraging of the SLC becomes even more critical. As noted above, the current SLC caps are too low to accommodate deaveraging. Increasing the SLC caps on a transitional basis will minimize the amount of universal service support necessary to ensure full recovery of common line costs.

Price cap carriers should also be permitted to deaverage the switching rate structure. While the geographic differences in cost may be less dramatic for traffic sensitive costs than for loops, cost differences do exist. For example, a smaller switch typically is deployed in rural areas where there are fewer customers than in urban areas. The switching-related costs per line will be higher in the rural area. LECs should be permitted to utilize zone pricing for traffic sensitive costs to accommodate these variations.[11]

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[10] *See,* for example, USTA Ex Parte Letter, CC Docket Nos. 96-45, 96-262, September 18, 1998.

III. PHASE TWO PRICING FLEXIBILITY FOR SWITCHED SERVICES SHOULD BE CONSISTENT WITH THAT ADOPTED FOR TRANSPORT SERVICES.

In the Pricing Flexibility Order, the Commission did not adopt Phase II pricing flexibility for common line and traffic-sensitive services or for the traffic-sensitive components of tandem-switched transport services. USTA believes that the Phase II triggers and relief should be similar to those the Commission adopted for transport services. Specifically, price cap carriers should be permitted to remove switched services from price cap regulation on a MSA/RSA basis based on a showing that competitors, in aggregate, offer service to at least 50 percent of the customer locations in a MSA. USTA believes that the Phase II triggers are objective, easily verifiable and can be used expeditiously to evaluate requests for flexibility for switched access services. These triggers demonstrate that competitors serve a significant portion of the market such that market forces will provide customer benefit.

Consistent with the Commission's order, an alternative showing should be permitted that would enable price cap carriers to demonstrate that competitors in aggregate offer service to customer locations that represent at least 65 percent of the price cap incumbent's common line SLC revenue in the MSA or RSA. This alternative is just as important for switched services as for transport services. The concentration of SLC revenues in specific areas and for certain classes of customers is extremely high. Therefore, in some MSAs, a price cap carrier may have a high percentage of its SLC revenue earned in areas where competitors are offering services but where less than 50 percent of its total customer locations are located. The price cap carrier should not be denied flexibility under these circumstances. As the Commission explained, competitors are drawn to new markets by the prospect of earning revenues, rather than to merely

[11] USTA notes that there is no need to mandate deaveraging of the switching rate structure. The proposal submitted by the Coalition for Affordable Local and Long Distance Service (CALLS) would permit carriers choosing to

provide capacity. The Commission, therefore, correctly recognized that revenue is an appropriate indicator of market entry.

The Commission should also permit price cap incumbents to make their showing based on the class of customer served. This would allow these carriers the opportunity to address the fact that competitors generally target business customers when entering a new market. Since the number of business locations may be a relatively small percentage of total customer locations in a MSA, a price cap incumbent could conceivably lose its total business market before obtaining Phase II relief if it was limited to showing that fifty percent of its total customer locations were served by competitors.

While USTA has recognized that specific safeguards may be appropriate for switched services, they should be limited and targeted. For example, in Phase II for switched services, it could be appropriate to cap the common line rates for a specified period of time.

IV. THE COMMISSION'S PROPOSALS REGARDING MANDATORY LOCAL SWITCHING RATE STRUCTURE CHANGES ARE UNNECESSARY AND ILL-ADVISED.

A. The Commission Should Not Mandate a Capacity-Based Local Switching Charge.

The Commission requests comment on whether it should require price cap LECs to implement a capacity-based rate structure for local switching. Specifically, the Commission proposes that LECs calculate a capacity-based local switching charge by considering the aggregate number of trunks switched by the LEC. USTA strongly urges the Commission to refrain from imposing any mandated rate structure on the price cap LECs. An option to use a capacity rate structure for local switching is reasonable and should be permitted.

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implement the proposal to lower their traffic sensitive charges. Deaveraging may not be necessary in those cases.

The current local switching rate structure includes a per minute of use charge and flat rated trunk port and line port charges. Incumbent price cap LECs are permitted to establish signaling and call set up charges pursuant to specific criteria. The Commission appears to be concerned that local switching returns have increased while local switching costs have remained static. The Commission proposes several changes to "fix" this perceived "problem". The fact is that there is no "problem" and thus, that the "fix" is unwarranted and unjustified.

The Commission's analysis of the alleged problem is flawed because it addresses local switching in isolation instead of evaluating local switching as part of the overall price cap plan. The analysis fails to recognize that a total company productivity factor is applied to all interstate prices and it is impossible to calculate separate X-Factors for specific services. While local switching may have a higher return, other price cap baskets may have a low or even a negative return. The Commission must evaluate the total price cap plan before it begins to tinker with specific parts.

The fact is that local switching expenses do not reflect declining costs. USTA has provided data showing that total regulated local switching investment has increased 22 percent and intrastate local switching investment has increased 25 percent since 1991.[12] Interstate local switching has remained flat during this period. As USTA explained, however, from 1991 to 1993 local switching average net investment declined due to the phase down of Dial Equipment Minutes (DEM) and the reassignment of line ports to the Common Line Basket in 1998. In addition the rapid growth of Internet usage, which is classified as local despite the fact that the Commission has acknowledged that calls made to Internet destinations are much more likely to be jurisdictionally interstate than local, results in less costs being assigned to the interstate

[12] USTA Ex Parte Letter, CC Docket No. 96-262, July 13, 1999.

jurisdiction. The magnitude of this arbitrary bias is significant. NECA estimates that approximately 18 percent of 1998 local/intrastate DEM represent Internet traffic.[13] Treating this traffic as jurisdictionally intrastate produces a $170 million misallocation of costs for the NECA companies alone. The impact on the LEC industry as a whole is substantial. For example, the Commission required SBC to reassign approximately 23 billion DEMs from the interstate to the intrastate jurisdiction. This reassignment misallocated over $117.5 million of costs to the intrastate jurisdiction for just one company.[14] These arbitrary allocations have given the appearance that cost levels are declining. Price cap regulation, however, removes the link between costs and prices. The Commission's proposal to alter the rate structure due to the impact of arbitrary cost allocations is completely inconsistent with the purpose of price cap regulation.

As Dr. Taylor explains in the attached statement, there is no compelling reason to completely alter the current rate structure to recover switching costs by using a capacity-based switching charge that utilizes trunks as the vehicle for recovery. A capacity charge based on trunks is really just another form of traffic-sensitive recovery. There is no economic reason why trunks would be preferred over minutes as the basis for recovery.

The current traffic-sensitive structure recovers costs on a per-minute basis primarily because engineering/economic cost studies and econometric analyses identify minutes as an important cost driver of switching. Switching costs reflect the number of lines and trunks connected to the switch (physical connections), the frequency of setting up a call (to determine the quantity of touch-tone receivers, MF register/servers), the average call holding time (to

[13] Letter from Richard Askoff, Deputy General Counsel, NECA, to Lawrence E. Strickling, Chief, Common Carrier Bureau, October 5, 1999.

determine the number of internal links or paths through the switch), and the real time capacity of the switch processor(s). The existing rate structure was initially based on the investment cost of switches plus expense divided by total minutes, not peak minutes. This is an economically sound methodology to measure and recover traffic-sensitive costs and to ensure that there is no under or over-recovery. In addition, price cap regulation constrains revenues so that regulated prices simulate the prices in unregulated, competitive markets. This ensures that recovery of switching costs occurs only if certain efficiencies are achieved.

While a capacity-based structure may provide incentives to IXCs to increase traffic during off-peak periods and may be beneficial to carriers that have a balanced pattern of traffic, there are significant disadvantages that compel the Commission to refrain from mandating the adoption of a capacity-based structure. Dr. Taylor points out that it would be a mistake to mandate such a structure because some of the problems of implementing a peak-sensitive pricing system based on minutes apply equally to a rate structure based on trunks. Specifically, Dr. Taylor explains that any potential gain from a capacity-based rate structure would be offset by implementation costs. The information requirements would be significant.

> For example, to the extent that peak period switch processor capacity is correlated with both dedicated and common trunks terminating at the switch, one would need to attribute use of common trunks to particular carriers, which for practical purposes is little different than measuring minutes. More fundamentally, it is not at all clear that the relationship between trunks and peak period processor demand is stronger than the relationship between minutes of use and peak period processor demand. The demand of carriers for trunking resources is determined by *their* peak demands, which do not necessarily coincide with the peak demand for the switch itself. The latter demand is determined by the volumes delivered by not only these carriers (whose own peak periods might differ from one another) *but all other peak usage for that switch, e.g., local calling.*[15]

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[14] The 23 billion DEMs represent only the Internet traffic SBC identified that was delivered to CLECs serving ISPs. The actual DEM associated with Internet traffic is significantly greater.

[15] Statement of Dr. William Taylor appended hereto.

Dr. Taylor observes that peak pricing for access charges does not necessarily lead to peak pricing for end user services. Access charges are just one input that makes up long distance prices. IXCs have their own switches that may have peaks that occur at different times. Peaks for ILEC switches differ based on many factors. ILEC switches provide a broad range of services such as local calls, intraLATA calls and interstate calls. The demand for all of these services, not just the interstate calls, determines what is the peak. Clearly, the peak will differ based on geographic location, customer calling patterns and type of switch. The Commission has no basis or information with which to mandate a peak or capacity pricing structure. In any event, the market seems to be moving away from time of day pricing to a single usage rate for all minutes of use. Surely the Commission would not mandate a structure that does not reflect customer preference.

In addition, such a structure could penalize smaller IXCs that lack economies of scale to purchase sufficient capacity for their high peak periods. It could also create uneconomic incentives for carriers to purchase links to all terminating end offices and additional lines to ensure sufficient capacity. This will result in the loss of sharing efficiencies causing higher overall switching investment and higher rates to many consumers. It could also create an adverse incentive for carriers to migrate direct trunked transport from low volume switches to tandem switches.

Likewise, the Commission should not mandate the rate levels or rate relationships for switching charges. The Commission should permit the incumbents to determine the appropriate rate relationships for DS3 and DS0 charges. The Commission can utilize its authority under the tariff review process to determine if the rates are just and reasonable.

The Commission has already concluded that volume and term discounts are necessary for incumbent LECs to respond to competition and has permitted these carriers to offer volume and term discounts when they have met the Phase I triggers.[16] Volume and term discounts will not disadvantage smaller IXCs and should be permitted in Phase I for switched access services even under a capacity-based rate structure. As the Commission notes, smaller IXCs can purchase and resell local switching services. In fact, a resale market for trunk ports has already developed. There is no need for the Commission to mandate per-minute or per-call structures concurrently with non-traffic sensitive charges. This will only encourage arbitrage, which will place incumbent LECs at a competitive disadvantage. In the Pricing Flexibility Order, the Commission established a framework to permit price cap LECs the opportunity to respond to market forces. There is no need for the Commission to negate that opportunity by re-engineering and micromanaging the access rate structure. The Commission should proceed with its transition to a market-based approach for the pricing and structure of access charges.

B. The Commission's Proposal to Include a "q" Factor in the Traffic-Sensitive PCI Formula is Based on Incorrect Assumptions and Should Not Be Adopted.

The Commission proposes to include a factor in the traffic-sensitive PCI formula similar to the "g" factor currently in the common line PCI formula if it adopts a capacity-based local switching rate structure. According to the Commission, the basis for adopting a "g/2" factor in the Common Line basket was the fact that while increased minutes leads to an increase in LEC revenues, Common Line costs do not increase as usage increases because they are non-traffic sensitive. The Commission states that if local switching costs are more appropriately recovered through capacity-based charges, then permitting LECs to charge per-minute local switching rates since LEC price cap regulation was adopted in 1991 may have created an imbalance between the

[16] Pricing Flexibility Order at ¶ 124.

interests of IXC customers and LEC stockholders. The Commission assumes that above-normal returns in the Traffic Sensitive basket may be explained by the error in the Traffic Sensitive rate structure and, therefore a one-time adjustment to the formula to correct for this alleged error is required. This assumption is fundamentally incorrect.

The Commission has made this assumption without any empirical data demonstrating that minutes have grown faster than trunks. The Commission is proposing to tinker with the price cap formula based on a change in the rate structure that may be wholly inappropriate or even irrelevant in the changing market. The Commission is not qualified to forecast future market outcomes. The fact is that price cap regulation is working. Higher earnings and lower access prices are signs of success not failure. The compounded benefits IXCs have received under price cap regulation from January 1, 1991 through June 30, 1999 amounts to almost $23 billion.[17] The one-time adjustment proposed by the Commission is an unwarranted throwback to rate of return regulation. It will destroy the efficiency-enhancing incentives of price cap regulation and must be rejected.

Dr. Taylor explains that it is economically erroneous to conclude that ILECs are earning above normal profits based on an examination of accounting data in individual price cap baskets. Accounting data fail to consider economic opportunity costs and therefore cannot be relied upon to determine real economic return. Simply stated, earnings analysis cannot be done at the basket (or interstate only) level. It is well established that telecommunications production is characterized by the existence of a significant amount of inputs that are common to many

[17] In fact, under the 6.5 X-Factor, benefits have been shifted away from the LECs toward the IXCs at rates faster than can be justified by the Commission's own model. Based on the most recent data and the Commission's model, the 1998 X-Factor should be 3.03 percent. The five-year average should be 4.06 percent. The average over the 1991 through 1998 price cap period is 4.12 percent. The Commission ordered X-Factor over the same 1991 through 1998 period averaged 5.12 percent. USTA Ex Parte Letter, CC Docket No. 94-1, September 10, 1999.

services. In order to estimate earnings the way the Commission suggests requires reliance on separations. The arbitrary and imprecise nature of the jurisdictional separations process further invalidates the Commission's analysis.

Regulatory accounting distorts both the level and growth of price cap LEC earnings. USTA has provided evidence that when accounting rates of return are adjusted to approximate economic rates of return, the actual rate of return achieved by the price cap LECs from 1991 to 1995 averaged only 8.75 percent.[18]

Further, Dr. Taylor explains that there is no basis to assume that price cap LECs enjoyed a windfall as a result of alleged errors in the Traffic Sensitive rate structure. Dr. Taylor compares the operating incomes of the RBOCs with the Value Line Industrials. Neither the level nor the growth in price cap LEC interstate or intrastate earnings is out of the range observed in unregulated competitive markets. As an empirical matter, price cap LECs have not performed as well as the average industrial firm. At the same time, price cap LEC customers have done considerably better as a result of price cap regulation.

Price cap LECs would not even have an opportunity to enjoy such an alleged windfall due to the calculation of productivity the Commission has relied upon. Use of either the indirect (historical price) approach or a direct TFP approach to calculate productivity precludes any alleged windfall from occurring.

The X-factor in place until 1997 was based, in part, on the Frentrup-Uretsky study that examined the trend in LEC interstate prices for switched access between 1984 and 1990. The initial rates for price cap LECs in 1991 were specifically determined to obtain a zero excess profit result. The indirect method of calculating an historical X factor used historical trends in

[18] USTA Ex Parte letter, CC Docket Nos. 94-1 and 96-262, May 29, 1998.

telecommunications prices relative to the economy as a whole. The indirect approach calculates the X-Factor to be the value required in 1984 that would just reproduce the growth in prices (unit revenues) over the period that would have occurred if regulation had kept earnings constant. When the historical rate of growth of prices (keeping earnings constant) is used to measure X, the fact that non-traffic sensitive costs may be recovered on a minute of use basis does not give rise to an over-recovery of costs. As long as the relationships among revenues, line growth and minutes growth are approximately constant over time, the alleged windfall from recovering fixed costs on a minute-of-use basis occurs during the historical period as well as the future, and its effect is fully reflected in the value of X necessary to maintain an appropriate balance among shareholders and ratepayers. Dr. Taylor demonstrates that using the indirect method, recovering non-traffic sensitive costs on a traffic sensitive basis does not result in a windfall.

Since 1997, the X-factor is determined based on the direct TFP methodology, which incorporates the effects on overall productivity of all inputs. A formula that includes an adjustment for demand growth effectively double-counts the productivity gains reflected in the measure of TFP. Any differences in the growth of inputs and outputs are captured in a TFP analysis. No adjustment is needed.

However, a lower X-Factor will be required if the Commission adopts the "q" factor. As Dr. Taylor explains, switching to a different output measure and price structure based on the Commission's erroneous assumptions (slower growing output) would require a lower X-Factor. Since productivity growth equals output growth minus input growth, changing a component of output to a slower growing measure lowers measured productivity growth.

Finally, Dr. Taylor notes that the Commission, in effect, already "corrected" for any alleged windfalls during the first four years of price cap regulation in the LEC Price Cap Performance Review when it removed the 1984/85 data point resulting in a higher X-Factor.

C. The Proposal to Increase the g/2 Factor in the Common Line Formula is Flawed and Should Not Be Adopted.

The Commission also proposes to increase the "g/2" factor in the common line formula to a full "g" because of alleged evidence that the IXCs influence per minute growth more than the LECs. Dr. Taylor describes several flaws in this proposal.

First, as discussed above, the "g/2" factor should already have been eliminated because the use of either the indirect or direct TFP approach to calculate the X-Factor makes the use of a "g" factor unnecessary and penalizes the price cap LECs.

Second, as a practical matter, the proportion of revenues from the CCL charge is decreasing significantly and, in fact, most price cap LECs have already eliminated the CCL charge.[19] The alleged problem that gave rise to the "g" in the first place (minutes growing faster than lines) is no longer an important issue. Dr. Taylor demonstrates that the growth in minutes per line has been decreasing significantly since the mid 1980s.

Finally, it is incorrect to attribute all long distance growth to the IXCs. As Dr. Taylor explains, increases in long distance consumption are primarily due to lower prices. Given that long distance prices have decreased, it is not likely that IXC marketing and advertising has played a significant role in stimulating market demand.[20] Rather, long distance demand growth is primarily due to lower long distance prices resulting from decreases in access charges and

[19] For all price cap carriers, the remaining CCL revenue recovers only about five percent of total common line revenues. In addition, about fifty percent of that CCL revenue recovery is for the recovery of universal service obligations.

shifts in the long distance supply curve because of increased competition. There is no justification to move to a full "g".

Given that the Commission has already recognized that retaining a "g" factor in the common line formula results in a double count when a TFP methodology is used to calculate the X-Factor, the Commission should focus on speeding up the process of recovering NTS costs through flat rates rather than micromanaging the division in "g" between IXC and LEC shareholders. This proposal is inappropriate and should not be adopted.

D. There is No Need for the Commission to Mandate Revisions to the Rate Structure for Tandem Switched Transport.

The Commission also solicits comment on whether any of its proposals should also be applied to the rate structure for tandem-switched transport. For the reasons stated above, there is no need for the Commission to mandate any of the changes as discussed above for tandem-switched transport. The proposed changes are equally inappropriate and ill advised for tandem-switched transport as they are for local switching. Carriers are in the best position to determine the appropriate relationship between tandem and direct-switched traffic. There is no need to re-engineer the tandem-switched transport rate structure. The Commission should continue the transition to a market-based approach to access pricing by continuing to streamline and eliminate regulations.

E. The Price Cap Basket Structure Should be Streamlined.

The Commission requests comment on whether it should modify the price cap rules to place flat rate charges and traffic-sensitive charges in separate baskets to prevent LECs from eliminating existing flat trunk port charges, thereby circumventing the local switching rate

[20] Access and other interconnection expenses were 33.8 percent of AT&T's long distance revenues in 1998, 35.9 percent in 1997 and 35.8 percent in 1996. AT&T Annual Report 1998 at p. 33.

structure rules. There is no evidence that that has occurred. The Commission should be looking at ways to decrease the number of baskets to facilitate the market-based approach. USTA has already provided the Commission with a proposal to simplify the price cap basket structure and to reduce the number of baskets.[21] The micromanagement of price cap baskets as proposed in the FNPRM must be rejected.

V. THE COMMISSION'S PROPOSALS TO REGULATE CLEC TERMINATING ACCESS ARE PREMATURE AND CONFLICT WITH THE MARKET-BASED APPROACH TO ACCESS PRICING.

The Commission seeks comments on whether any statutory or regulatory constraints prevent AT&T from declining a CLEC's access service. USTA maintains that such statutory constraints do exist and that AT&T would be precluded from arbitrarily declining a CLEC's or ILEC's access service.

Section 201(a) makes clear that it "shall be the duty of every common carrier engaged in interstate ... communication ... to furnish such communication service upon ... request...."[22] A common carrier is defined as "any person engaged as a common carrier for hire, in interstate.... communication by wire or radio....[23] Section 251(a) of the Act imposes upon telecommunications carriers "the duty to interconnect directly or indirectly with the facilities and equipment of other telecommunications carriers."[24] A telecommunications carrier is defined as "*any* provider of telecommunications services...."[25] Telecommunications service is defined as "the offering of telecommunications for a fee directly to the public, or to such classes of users as

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[21] USTA Comments, CC Docket No. 96-262, October 26, 1998 at Attachment F.
[22] 47 U.S.C. § 201(a).

[23] 47 U.S.C. §153(10).

[24] 47 U.S.C. §251(a).

[25] 47 U.S.C. §153(44).

to be effectively available directly to the public, regardless of the facilities used."[26] The Act further defines telecommunications as "the transmission, between or among points specified by the user, of information of the user's choosing, without change in the form of content of the information as sent or received."[27]

USTA believes that these statutory provisions prevent AT&T from unilaterally disrupting services to end users by simply refusing to pay originating or terminating access based on CLEC or, for that matter, ILEC access tariff rates. If AT&T or any carrier finds tariffed rates to be unjust or unreasonable, the remedy is found in Section 208, where any party may file a complaint with the Commission. Indeed, the Commission is authorized to determine if rates are just and reasonable as required by Section 205 of the Act. Sections 205 and 208 reflect Congressional intent that the Commission "shall" make determinations regarding whether any rate is just and reasonable.[28] The Commission has correctly concluded that the marketplace, not government mandates, should drive competition in the market for access services.[29] USTA agrees that marketplace solutions, coupled with the Commission's complaint process, are the proper fora to determine if CLEC access rates are just and reasonable.

As a matter of public policy, any proposal which would permit AT&T to "pick and choose" which end users it will terminate calls to within its service territory based upon whether it unilaterally disapproves of the tariffed access rates of CLECs or ILECs, would limit customer

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[26]47 U.S.C. §153(46).

[27]47 U.S.C. §153(43).

[28]Generally speaking, courts have read "shall" as a more direct statutory command than words such as "should" and "may" in the context of interpreting the intent of Congress regarding agency action." *See Texas v. FCC,* No. 97-60421, slip op. at 11, www.ca5.uscourts.gov/opinions/pub/97/97-60421-cvo.HTM, *citing MCI v. FCC*, 765 F.2d 1186, 1191 (D.C. Cir. 1985)(holding that "shall" is the "language of command").

[29]"We strongly prefer to rely upon a marketplace solution...." *See* FNPRM at 124,¶247.

choice, create customer confusion, reduce competition, preclude its obligations under Section 201 and could result in an increase in under-served and unserved regions of the country. AT&T should not be permitted to make an end run around existing administrative remedies such as the Commission's complaint process in Section 208 of the Act, particularly when access rates are tariffed.[30] This would render the Commission's review procedures useless. An IXC would need only declare that tariffed access rates of a given CLEC or ILEC are excessive and simply refuse to provide service to those customers. In essence, the IXC would be determining what access rates are just and reasonable and what customers and localities it will serve without penalty. Such a policy would undermine a customer's right to terminate calls to anyone connected to the public switched network. USTA urges the Commission to recognize these adverse impacts and require IXCs to use the statutory procedures mandated by the Act to contest tariffed access rates. In this way the Commission, not the IXC, can make the finding of whether specific tariffed access rates are just and reasonable as Congress intended.

The Commission seeks comment on whether section 254(g) permits IXCs to charge different rates to end users within the same geographic area based upon the level of access charges levied by the end user's local exchange company. Section 254(g) provides in part:

[30]Carriers must also comply with Section 214 requirements regarding the withdrawal of service.

> [T]he Commission shall adopt rules to require that the rates charged by providers of interexchange telecommunications services to subscribers in rural and high cost areas shall be no higher than the rates charged by each such provider to its subscribers in urban areas. Such rates shall also require that a provider of interstate interexchange telecommunications services shall provide such services to its subscribers in each State at rates no higher than the rates charged to its subscribers in any other State.[31]

Section 254(g) does not permit AT&T to charge customers higher rates for interexchange service in rural areas versus urban communities or between states served by the carrier. Section 254(g) does not apply to access charges which do vary geographically and for which the Commission has provided flexibility in the Pricing Flexibility Order. Any Commission decision that places at risk universal service would be inconsistent with the Act. The Commission must ensure that its policies are consistent with the goals and objectives of universal service as specified by Congress in Section 254(b).

The Commission also seeks comment on whether mandatory detariffing of CLEC interstate access charges might address any market failure to constrain terminating access rates. According to the Commission, "mandatory detariffing would eliminate the CLECs' ability unilaterally to set terminating access rates by filing a tariff and to avoid negotiating those rates in the marketplace by relying on the filed tariff doctrine."[32] Mandatory detariffing is not permitted under the Act. When a carrier files a tariff, the filed rate doctrine applies. In a recent decision, the Supreme Court reiterated the supremacy of the filed rate doctrine when the Court concluded that the filed rate doctrine is a bar to state law contract and tort suits against a common carrier.[33]

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[31] 47 U.S.C. §254(g).

[32] *Id.* at 123-124, ¶246.

[33] *AT&T v. Central Office Telephone*, 524 U.S. 214, 118 S.Ct. 1956 (1998).

In ruling in favor of AT&T's filed rate doctrine arguments, the Court held that: "While the filed rate doctrine may seem harsh in some circumstances... its strict application is necessary to prevent carriers from intentionally misquoting rates ... as a means of offering ... rebates or discounts, the very evil the filing requirement seeks to prevent. Regardless of the carrier's motive - whether it seeks to benefit or harm a particular customer - the policy of nondiscriminatory rates is violated when similarly situated customers pay different rates for the same services. It is that anti-discriminatory policy which lies at the heart of the common-carrier section of the Communications Act."[34]

In addition, Section 10[35] of the 1996 Act provides "that only the Commission, and not customers, carriers, or courts, should determine when it is appropriate to permit contracts that are not subject to the filed rate doctrine."[36] Section 10 "requires the Commission under certain circumstances to exempt common carriers from any obligation to file tariffs for interstate services, thus leaving to the Commission the exclusive authority to determine when the filed rate doctrine should or should not apply."[37]

As an alternative to marketplace solutions, the Commission asks whether the incumbent LEC's terminating access charges should serve as a benchmark to evaluating the reasonableness of CLEC terminating rates. If a benchmark is deployed, the Commission seeks comment on whether CLECs that wish to do so, could charge the end-user (either called or calling party)

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[34] *Id.* States also have tariffing requirements.

[35] 47 U.S.C. §160.

[36] *Amicus Brief of United States Telephone Association, BellSouth Telecommunications, BellSouth Corporation, Pacific Bell, and Southwestern Bell Telephone Company* at 4.

[37] *Id.* USTA supports permissive detariffing. Should the Commission not permit CLECs to provide access services pursuant to tariffs, it could be administratively burdensome and costly for CLECs to negotiate separate contracts with every facilities-based carrier.

more than the benchmark to collect those charges and whether a calling party pays arrangement should be adopted to notify the end-user of the additional charges.

USTA opposes the imposition of rate regulation on CLECs as proposed in the FNPRM. At a time when the Commission is seeking to encourage competition and to reduce regulation in competitive areas, new regulations imposed on CLECs are, at best, premature, and at worse incongruous with the 1996 Act. USTA continues to urge the Commission to continue to rely on market solutions rather than regulation. In a competitive market, CLECs and ILECs should be permitted to bill end users. However, for many companies billing the end user could be administratively burdensome and costly, therefore it should not be mandated.[38] Regarding the use of calling party pays to notify the end users of additional charges associated with the call, USTA has already commented that mandatory calling party pays should not be adopted. Billing and collection is a detariffed service, not a network element, and should not be unbundled. Customer notification should be resolved by the telecommunications industry, not by Commission regulation.[39] The marketplace, not regulation, will ensure the appropriate CLEC terminating access rates. AT&T, and any other carrier, can challenge CLEC access rates through existing Congressionally mandated review and complaint procedures established by the Commission.

VI. CONCLUSION.

The Commission must pursue policies that rely on market forces rather than regulation to ensure efficient pricing, production and investment. The Commission must proceed

[38] CAB systems are not designed to bill end users for switched access. For example, CAB systems don't carry end user line numbers for originating or terminating access, and they bill at the wire center or NPA NXX level.
[39] USTA Comments, *Calling Party Pays Service Offering in the Commercial Mobile Radio Service*, WT Docket No. 97-207 (September 17, 1999).

expeditiously to complete the transition to the market based approach for the pricing of access services by adopting the Phase II pricing flexibility and deaveraging as recommended by USTA. The Commission must reject those proposals that would impose new mandatory rate structure regulation on price cap LECs. The Commission should not mandate a capacity-based rate structure for local switching as the Commission lacks sufficient justification to adopt such a proposal. In addition, the Commission should not adopt the unnecessary and ill-advised changes to the price cap formula it has proposed.

Respectfully submitted,

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October 29, 1999

CERTIFICATE OF SERVICE

I, Donna Young, do certify that on October 29, 1999, copies of the accompanying Comments of the United States Telephone Association were either hand-delivered, or deposited in the U.S. Mail, first-class, postage prepaid to the persons on the attached service list.

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