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

In the Matter of	)	
	)	
Access Charge Reform	)	CC Docket No. 96-262
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
Interexchange Carrier Purchases of Switched Access Services Offered by Competitive Local Exchange Carriers	)	CCB/CPD File No. 98-63

REPLY COMMENTS OF THE UNITED STATES TELECOM ASSOCIATION

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SUMMARY

USTA's reply comments make the following points regarding the comments filed on October 29, 1999:

- Geographic deaveraging of switched access services within a study area is in the public interest and should be adopted without a competitive showing immediately to eliminate uneconomic market distortions.

- There should be no preconditions to implementation of geographic deaveraging. The Commission has already found that such flexibility will not lead to predatory pricing because deaveraging implies price decreases as well as increases and that prices which align more closely with costs decreases the possibility of improper cross subsidization.

- The Commission has also found that it is unlikely that such deaveraging will place greater pressure on IXCs to deaverage. The Act requires averaged interstate interexchange service rates. The Act also requires that implicit subsidies be made explicit. Incumbent LECs cannot be required to recover universal service contributions through interstate access charges.

- Deaveraging of traffic-sensitive access elements is necessary to accommodate variations in switching costs.

- The Commission should complete its work on the pricing flexibility framework and adopt Phase II triggers for switched access. Concerns that competition is insufficient have been refuted by the Commission and do not justify delay in completing the framework. If the competitive triggers cannot be demonstrated, flexibility will not be granted.

- A market share test for pricing flexibility should not be adopted because it is inconsistent with standard economic principles as explained in the attached paper by Dr. William Taylor of NERA. Such a test does not measure market power, would prevent customers from receiving lower prices, would create perverse incentives not to compete aggressively for customers and has already been rejected by the Commission.

- The record before the Commission clearly requires that the Commission not mandate a capacity-based rate structure for local switching as every carrier objected to the Commission's proposal.

- An analysis or the traffic sensitive nature of switching costs performed by INDETEC and attached hereto reveals that switching costs are variable and underscore the inappropriateness of the Commission's proposed adjustments to the PCI formula.

- Professor Frank Gollop disputes the phantom windfall as claimed by several parties and demonstrates that the X-Factor already reflects growth in local switching minutes as well as changes in capacity utilization. Adopting a "q" factor would result in double counting. No windfall has occurred.

- Adoption of a "q" factor would necessitate a reduction in the X-Factor because output must be redefined.

- Professor Gollop also explains that earnings performance, which is evaluated under a rate of return paradigm, is inconsistent with price cap regulation and with economic principles. The common-input technology of the industry prohibits any "interstate-only" analysis based on arbitrary, historical accounting-based separations.

- Dr. Taylor confirms Professor Gollop's findings and disputes AT&T's incorrect assertion that costs of local switching do not increase with growth in traffic. He points out that AT&T relies on the economically meaningless separations process to support its claim of a windfall when in fact, changes in the Part 36 and 69 rules adopted by the Commission and increased Internet usage have significantly reduced investment and expenses allocated to the interstate local switching category.

- There is no demonstrated need to impose regulation on CLEC terminating access charges. The Commission should continue to rely on market forces and the IXCs should utilize the complaint process instead of illegal self-help measures.

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REPLY COMMENTS OF THE UNITED STATES TELECOM ASSOCIATION

The United States Telecom Association (USTA) respectfully submits its reply to the comments filed October 29, 1999 in the above referenced proceeding.[1]

I. INTRODUCTION AND SUMMARY.

In its comments, USTA supported deaveraging of interstate common line and traffic-sensitive access charges within a study area without a competitive showing. USTA explained that deaveraging would enhance economic efficiency as it will result in more economic pricing and improved utilization of resources and will optimize the level of network element and facilities-based competition. USTA urged the Commission to adopt Phase II pricing flexibility for switched services similar to that adopted by the Commission for transport services and to provide an opportunity for price cap LECs to make a showing based on the class of customer served.

USTA strongly opposed the Commission's proposal to mandate a capacity-based rate structure for local switching costs, pointing out that local switching costs are not declining and that the majority of these costs are now being assigned to the intrastate jurisdiction. USTA warned the Commission that the implementation costs of a mandatory capacity-based structure would certainly outweigh any potential benefits. USTA explained that there is no opportunity for price cap LECs to experience a windfall based on a putative misalignment between NTS costs and usage-based prices in the traffic sensitive basket due to the calculation of the X-Factor. Further, there is no evidence that such an alleged windfall occurred since neither the level nor the growth of price cap LEC earnings is out of the range observed in unregulated markets. The Commission's reliance on accounting data to attempt to support its claims of a windfall is economically erroneous since regulatory accounting distorts both the level and growth of earnings and relies on separations to estimate earnings at the basket (interstate-only) level which, of course, is inconsistent with price cap regulation. USTA urged the Commission not to adopt either the "q" or the "full g" adjustments. USTA explained that these adjustments are unnecessary and ill advised. However, USTA noted that if the "q" factor is adopted, the X-Factor must be lowered.

Finally, USTA stated that AT&T should not be permitted to unilaterally decline to terminate calls to end users because it does not like the terminating rates charged by a CLEC. USTA recommended that the Commission continue to rely on the market to ensure appropriate rates. AT&T and any other carrier can challenge CLEC terminating access rates through the complaint process.

In its reply comments, USTA refutes the suggestions made by AT&T and MCI that the Commission should impose unrelated conditions prior to the adoption of geographic deaveraging. USTA also refutes those parties that suggest that the Commission should not adopt Phase II pricing flexibility triggers. Dr. William Taylor of the National Economic Research

[1] Formerly the United States Telephone Association.

Associates (NERA) in the attached reply comments explains that pricing flexibility should not be based on any type of market share test (Attachment 1). USTA notes that the record demonstrates that the industry does not want a capacity-based rate structure for local switching. Every carrier agreed that such a rate structure should not be required. Attached to USTA's reply is a report prepared by Brian S. Delidow and Dr. Steve G. Parsons of INDETEC International which describes the nature of telecommunications economic switching costs and concludes that switching costs do vary with traffic (call attempts and minutes of use) disproving the assumptions contained in the FNPRM (Attachment 2). Dr. Taylor and Professor Frank Gollop of Boston College both refute arguments regarding the proposed "q" and "g" adjustments to the PCI (Professor Gollop's paper is Attachment 3). Finally, USTA notes that the Commission should continue to rely on market forces rather than regulation to ensure appropriate CLEC terminating access rates.

II. GEOGRAPHIC DEAVERAGING OF SWITCHED ACCESS SERVICES WITHIN A STUDY AREA IS IN THE PUBLIC INTEREST AND SHOULD BE ADOPTED WITHOUT A COMPETITIVE SHOWING.

No party disputes the fact that geographic deaveraging of switched access services within a study area is in the public interest. AT&T, MCI and Time Warner appear to view geographic deaveraging of switched access services as a means to impose additional, unrelated regulatory conditions on price cap LECs, presumably in order to facilitate their competitive advantage. AT&T also seeks to obtain relief from the statutory requirement of Section 254(g) of the Telecommunications Act of 1996 which requires AT&T to maintain geographically averaged interexchange and interstate rates by stating that deaveraging of switched access should not occur until after AT&T is permitted to deaverage interstate interexchange services. AT&T

claims that without such conditions, LECs will engage in improper cross subsidization if permitted to deaverage.

The Commission has already recognized that such claims are without merit. In the Pricing Flexibility Order, the Commission explained that greater pricing flexibility will not lead to predatory pricing and "is unlikely to place significantly greater pressure on IXCs to deaverage their rates, in part because deaveraging implies price *decreases* as well as increases."[2] Further, as the Commission notes, prices that more closely reflect costs decrease the possibility of cross-subsidization. The Commission accurately describes the market distortions that averaging creates.[3] There is no valid reason to perpetuate these distortions by preventing the deaveraging of switched access services.

There is no provision in the Act that would in any way suggest that carriers should not be permitted to move toward a more economic alignment of prices and costs. In fact, the 5th Circuit Court of Appeals recently held that under Section 254(e) implicit subsidies used to support universal service must be explicit. The Court reversed the Commission's decision to require incumbent LECs to recover universal service contributions from their interstate access charges.[4] Geographic deaveraging which permits carriers to more appropriately align rates with the manner in which the costs for services are incurred is consistent with the statute. The Act is also clear that AT&T is required to provide interstate interexchange telecommunications services in each state at rates no higher than the rates charged to its subscribers in any other state under Section 254(g). There is no statutory basis to support AT&T's proposal to forestall geographic

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[2] 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, CC Docket Nos. 96-262, 94-1, 98-157 and CCB/CPD File No. 98-63, *Fifth Report and Order and Further Notice of Proposed Rulemaking*, FCC 99-206 (rel. Aug. 27, 1999) at ¶ 64. [Pricing Flexibility Order].

[3] *Id.* at ¶ 61.

[4] *Texas Office of Public Utility Counsel v. FCC*, No. 97-60421 (5th Cir. Jul. 30, 1999).

deaveraging of access services until the Commission determines that it can forbear from enforcing the statutory mandate that interstate interexchange services be averaged.

AT&T concedes that access charges include implicit subsidy.[5] As noted in USTA's comments, USTA previously submitted a plan to the Commission whereby nonrural carriers would replace the implicit universal service support derived from interstate access charges. Pursuant to USTA's plan, common line costs would be recovered explicitly through the SLC and the universal service fund. However, as common line costs are recovered from the SLC, deaveraging the SLC is imperative to limit the size of the universal service fund. Accordingly, USTA also submitted a proposal to deaverage the SLC for price cap carriers so that SLC caps would be set to more closely align with the interstate common line costs caused by the end user. As USTA explained however, the current SLC caps for nonrural carriers should be increased in order for deaveraging to be meaningful. USTA's proposal addresses AT&T's concerns regarding implicit subsidy. Contrary to AT&T's faulty logic, deaveraging is part of the solution and should accompany any transition mechanism to replace implicit support with explicit recovery. USTA's plan is similar to the plan developed by AT&T and others in the CALLS proposal. As AT&T notes, if these types of plans are adopted, there is no need for many of the regulatory proposals contained in the FNPRM. However, contrary to AT&T's assertion, and as USTA noted in its comments on the CALLS proposal, the CALLS plan would not be suitable for all LECs, particularly small, rural LECs. While USTA believes that carriers should be permitted to develop and implement such plans to resolve the universal service/access reform issues that the Commission has failed to address, such plans may not be appropriate for all carriers and thus should remain optional in nature.

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[5] AT&T at 4.

AT&T also opposes deaveraging of the traffic-sensitive access elements. As USTA pointed out in its comments, deaveraging is necessary to accommodate variations in switching costs. USTA notes that Sprint provides data depicting the geographic variations of local switching costs.[6] As Sprint explains, the clear inverse relationship between switching costs and density is typical for price cap LECs and thus underscores the need for deaveraging.

III. THE PRICING FLEXIBILITY FRAMEWORK MUST BE COMPLETED.

The Commission did not complete the framework by which price cap LECs would be permitted greater pricing flexibility based upon a showing that specified competitive triggers have been met. Several commenters suggest that the Commission need not complete its work because competition is "insufficient". This position makes no sense, contradicts the Commission's own findings regarding the extent of competition and does not justify further delay in the adoption of Phase II triggers for switched access as recommended by USTA in its comments.[7]

As the Commission points out, the purpose of the framework is to grant pricing flexibility to price cap LECs as competition develops. Price cap LECs can obtain regulatory relief only upon satisfaction of specific competitive showings. The existence of the framework itself does not guarantee regulatory relief. To obtain Phase I relief, price cap carriers must demonstrate that competitors have made irreversible, sunk investments in the facilities needed to provide the services at issue. To obtain Phase II relief, price cap carriers must demonstrate that competitors have established a significant market presence for provision of the services at issue. The

[6] Sprint at 7.
[7] The Commission found that, "as of March, 1999, approximately 167 different competitors have deployed approximately 700 switches throughout the country. When we analyze where requesting carriers have deployed these switches, we find that most of these switches have been deployed within the confines of the top 50 MSAs. According to USTA's data, which relies on the Local Exchange Routing Guide, approximately 61 percent of all requesting carrier switches nationwide have been deployed in the top 50 MSAs." In the Matter of Implementation

Commission should move forward and complete the framework by adopting Phase II triggers for switched access services as recommended by USTA. If competition is insufficient, as these commenters allege, the triggers will not be met and flexibility will not be granted. However, to ignore the development of competition, which no commenter disputes, and leave the framework incomplete is simply bad public policy.

As the Commission correctly observes, price cap regulation is supposed to replicate the efficiency incentives found in competitive markets and to act as a transitional regulatory mechanism until competition makes price cap regulation unnecessary. This is consistent with the general economic principle that where market forces are sufficiently robust, market forces and not regulation should be relied upon to determine results. Even where regulation is still required, however, it must not be permitted to determine results permanently. As competition develops, the Commission must be able to act quickly to ensure that regulation is competitively neutral. Demand is not evenly distributed across customers and competitors have demonstrated that they are only interested in high volume customers. The loss of a few large customers can have a severe financial impact on the incumbent. While competition inevitably means that customers will switch suppliers, it is inefficient and detrimental if customers switch, not because the new entrant was more efficient, but because regulation prevented the incumbent from competing.[8] It is imperative for the Commission to finish its work and establish the appropriate triggers by which switched access services can be removed from regulation as competition warrants.

AT&T and Time Warner argue that the primary criterion for obtaining Phase II pricing flexibility should be a market share test. In the attached paper, Dr. Taylor explains that such a

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of the Local Competition Provisions of the Telecommunications Act of 1996, CC Docket No. 96-98, *Third Report and Order* (re. Nov. 5, 1999) at par. 280.

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

test would be inconsistent with standard economic principles. Dr. Taylor urges the Commission to reject these proposals because they do not measure market power and, if adopted, would prevent customers from receiving lower prices. Dr. Taylor points out the self-serving nature of AT&T's arguments that are contrary to and inconsistent with previous positions it has taken.

Dr. Taylor explains that market share is not a good predictor of future pricing behavior and does not provide meaningful or accurate information about whether market power actually exists. He notes that the Commission, the Department of Justice and the Federal Trade Commission have all accepted that general principle. He observes that the Commission itself, in its decision to declare AT&T non-dominant, found that market share should not be the sole determining factor of when a firm possesses market power and that other factors, such as demand and supply elasticities, conditions of entry and other market conditions must be examined to determine whether a particular firm exercises market power in a particular market.[9] Market share is a better indicator of past regulation and does not capture the level and intensity of current and potential competition. Dr. Taylor concludes that an appropriate trigger will focus on examining the barriers to entering and expanding in the relevant geographic markets.

Another problem with market share as a trigger for pricing flexibility is that it provides market participants with perverse incentives. If pricing flexibility is conditioned upon losing a certain number of customers, it may provide an incentive not to compete aggressively for customers. In addition, since asymmetric regulation benefits competitors because it increases the incumbent's costs and prices, competitors may have an incentive to not target certain customers in order to prevent pricing flexibility for the incumbent. In either case, it is the customer who suffers from the reduced competition and it is the customer who is denied lower prices.

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[9] Motion of AT&T to be Reclassified as a Non-Dominant Carrier, *Report and Order,* FCC 95-427 (rel. Oct. 23, 1995).

Applying regulation when it is not economically necessary distorts the market because it moves the market outcome away from the competitive outcome.

Moreover, Dr. Taylor points out that the proposals of AT&T and Time Warner are particularly deficient because they advocate measuring market share based on customer locations rather than on a more appropriate measure, such as capacity. The Commission itself recognized in the AT&T Non-Dominance Order the importance of capacity because if competitors have capacity in place that can be brought on line at low additional cost so that the customer has a choice of suppliers, the incumbent cannot exercise market power. Indeed, AT&T itself argued in favor of capacity as opposed to customer location in that proceeding.

IV. THE RECORD BEFORE THE COMMISSION CLEARLY REQUIRES THAT THE COMMISSION NOT MANDATE A CAPACITY-BASED RATE STRUCTURE FOR LOCAL SWITCHING.

Based on the record before the Commission, no carrier supports the imposition of a capacity based rate structure for local switching.[10] The reasons provided by the carriers are consistent with USTA's arguments in this regard and demonstrate that there is no justification for imposing a capacity-based rate structure for local switching. In fact, the record demonstrates that such a move would be counter-productive.[11]

V. AN ANALYSIS OF THE TRAFFIC SENSITIVE NATURE OF SWITCHING COSTS UNDERSCORE THE INAPPROPRIATENESS OF THE COMMISSION'S PROPOSALS.

As further evidence of the inappropriateness of the Commission's proposals and the faulty assumptions upon which they are based, Brian Delidow and Dr. Steve Parsons of INDETEC describe the nature of telecommunications economic switching costs and the extent to which these costs are caused by traffic in the attached paper.

[10] *See,* for example, Comments of AT&T at 12, Bell Atlantic at 2, Time Warner at 4, Sprint at 11, U S WEST at 8, GTE at 26, MCI at 10, ALTS at 30-31, and CompTel at 5,

Delidow and Parsons clearly demonstrate that the underlying costs of providing switching are traffic sensitive. They categorize local switching costs as volume sensitive, service-specific (volume insensitive) and shared. They explain that switches have limited capacity in that capacity expands only through purchasing additional pieces of equipment, i.e., by providing additional, discrete "lumps" of capacity. This lumpiness in capacity adds complexity to cost analysis, but does not cause capital costs necessarily to be fixed or shared. The critical issue in properly evaluating the costs of using a switch is whether the capacity of the facility will exhaust. If the existence of an additional unit of service advances the time at which the facility will exhaust, then that unit of service has caused the costs to increase. They describe the type of capacity that will exhaust and the units of service within the switch that cause it to exhaust, disputing any inference that the capacity of a switch does not exhaust and thus that the costs of a switch are fixed. Based on their analysis, the vast majority of switching costs are impacted by capacity. Finally, they note that state regulators have consistently recognized that switching costs are traffic sensitive and that all of the cost models that have been developed over the past several years recognize that switching costs are variable.

This analysis demonstrates that since switching costs are variable, the Commission's proposed adjustments to the PCI are unnecessary and ill advised. It refutes the false assertion made by AT&T that it is appropriate to include a q factor in the traffic-sensitive PCI formula because the costs of local switching do not increase with growth in traffic. There is no justification for these adjustments. They only serve to arbitrarily force prices down without recognizing the relationship between costs and usage. USTA will discuss other reasons why these adjustments should not be adopted below.

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[11] Wisconsin PSC at 5.

VI. THE COMMISSION SHOULD NOT ADOPT A "Q" FACTOR OR A FULL "G"IN THE TRAFFIC SENSITIVE PCI FORMULA.

AT&T and Ad Hoc support the Commission's use of a "q" factor to adjust the Commission's traffic sensitive price cap index (PCI) formula. These parties, like the Commission, are confused about the existence of a phantom windfall and want to "fix" a problem that USTA demonstrated does not exist. In fact, an examination of the record reveals that no party provided any meaningful economic analysis to support the need for either a "q" factor or a full "g".

In the attached paper, Professor Gollop examines the phantom windfall, which supposedly results from a misalignment between costs driven by nontraffic-sensitive factors and revenues collected on a traffic sensitive basis. He disputes the inferences that the X-Factor is presumably insensitive to growth in local switching minutes and to changes in LEC capacity utilization and that the phantom windfall has occurred in spite of the Commission's own X-Factor model.

As Professor Gollop explains, the current X-Factor model captures the growth in local switching minutes per unit of capacity. In fact, the X-Factor model captures all costs and revenues. The growth in switched access minutes is explicitly incorporated into the measure of output growth and thereby enters directly into the calculation of LEC TFP growth. Even if AT&T is correct that costs (inputs) have grown more slowly than minutes (outputs), that growth differential has been captured as increased TFP growth and has automatically increased the measured X-Factor. This is true whether the LEC services are being offered in peak or off-peak intervals. Since the growth in local switching minutes has already been reflected in the X-Factor, adopting a "q" factor would constitute double counting.

He also explains that adopting the "q" factor would necessarily result in lowering the X-Factor because the output must be redefined. He performs a simulation to demonstrate that the effect of AT&T's proposed "q" adjustment requires modifying the measure of switched access output used in the TFP growth calculation. Replacing faster growing usage with slower growing capacity, consistent with AT&T's proposal, lowers the measured rate of TFP growth and therefore X. Using AT&T's data and incorporating it into the X-Factor model reduces the 1998 X-Factor from 3.03 percent to 1.74 percent. The five year average would decrease from 4.06 percent to 3.20 percent. Since X-Factors can only be adjusted on a going-forward basis, any "q" adjustment similarly could only be implemented on a going-forward basis. To do otherwise would only compound the double-counting effect. In fact, Professor Gollop notes that recently announced revisions to the U.S. government data series for the nonfarm economy suggest that the Commission must now consider another revision to the X-Factor. According to *Business Week*, the Department of Commerce is revising the nonfarm business productivity growth upward.[12] In addition to revising the X-Factor for "q" to avoid double counting, the Commission must also incorporate the forthcoming upward revision in nonfarm TFP.

Finally, Professor Gollop examines price cap LEC earnings using an economic framework that does not rely on the use of an arbitrary separations process. As Professor Gollop observes, price regulation should be linked to LEC productivity and input price performance using variables measured consistently with economic principles. It should not be governed by earnings performance measured under a rate of return paradigm inconsistent with price regulation. Further, it is settled that any economically meaningful evaluation of LEC price cap performance must be done at a total company level. The common-input technology of the industry prohibits any "interstate-only" analysis based on historical accounting-based separations

[12] *Business Week*, Nov. 8, 1999 at p. 34.

process. Evaluating price cap LEC performance against benchmarks for the nonfarm sector upon which both the PCI and the X are calculated show that price cap LECs have experienced no windfall gains. The only possible source for the phantom windfall is from "interstate-only" rates of return in a single price cap service basket. This requires allocations of both expenses and capital input using historical separations and accounting conventions adopted under rate of return regulation, which was retired over a decade ago. Moreover, the capital rate base used by AT&T is inconsistent with the Commission's measure of capital. Professor Gollop compares the growth rate of capital input under the Commission's X-Factor model with the Commission's rate base under rate of return to illustrate how AT&T creates the phantom windfall.

Dr. Taylor also refutes the notion of the phantom windfall. He points out that AT&T's assertion that the costs of local switching do not increase with growth in traffic is incorrect. He confirms Professor Gollop's analysis that AT&T's conclusions are dependent upon the economically meaningless separations process to estimate the investment, expenses and earnings at an interstate only level found in AT&T's Attachment B. AT&T conveniently ignores the Part 36 and 69 rules changes that have occurred and the increased Internet usage all of which have significantly reduced investment and expenses allocated to the interstate local switching category. These changes began in 1988 when the allocator of local switching investment was phased in to pure dial equipment minutes. The phase-in was completed in 1993. In 1993, the Part 69 rules were changed to shift a significant amount of general support facilities from the interstate access cost categories to the common line cost category. In 1998, the Part 69 rules changed again to shift interstate line port costs from the interstate local switching cost category to the common line cost category. Dr. Taylor addressed the impact of the assignment of Internet-bound minutes to the intrastate jurisdiction despite the fact that such minutes are jurisdictionally interstate in USTA's comments. The result of these changes has been to assign less switching investment and expenses to the interstate jurisdiction and, in particular, to the local switching category.

Further, Dr. Taylor points out that AT&T's observation that local switching minutes have grown while ARMIS investment and expenses associated with local switching have declined reveals only that average *separated* accounting costs have declined. This has no economically meaningful value and says nothing about the relationship between switching costs and switching usage. AT&T's faulty assertion is betrayed by the facts and does not lend credible support to the Commission's proposals.

VII. THERE IS NO DEMONSTRATED NEED TO IMPOSE REGULATION ON CLEC TERMINATING ACCESS CHARGES.

The comments do not indicate that there is a pervasive need to impose regulation on CLEC terminating access charges. USTA maintains that the Commission should continue to rely on market forces to determine the appropriate rates. As many commenters point out, the Commission has the authority to find rates unreasonable and to prescribe reasonable rates. Customers may file Section 208 complaints to object to excessive rates. These statutory provisions provide sufficient means for interexchange carriers to challenge CLEC charges. Additional regulations do not appear to be required at this time, although expedited consideration of such complaints may be one way in which the Commission could ensure that such disputes are resolved quickly so that IXCs are not encouraged to withdraw service from end user customers or to refuse payment.[13] AT&T should not be permitted to unilaterally decline to terminate calls to end users simply because it disapproves of the terminating rates of a CLEC. Such action undermines the Commission's statutory authority as noted above, renders the existing complaint

[13] U S WEST at 26.

process 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.

VIII. CONCLUSION.

The Commission should proceed with its efforts to complete the pricing flexibility framework. The Commission should immediately permit geographic deaveraging of switched access services for price cap carriers and adopt the triggers for Phase II pricing flexibility as recommended herein. The proposals to tie deaveraging to unrelated conditions and to adopt a market share test for pricing flexibility are uneconomic and must be rejected. The Commission should also reject any of the proposed adjustments to the PCI formula, as they are ill advised and unnecessary. The record does not support the adoption of a mandatory capacity-based rate structure for local switching.

Respectfully submitted,

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November 29, 1999

ATTACHMENT 1

REPLY COMMENTS OF
WILLIAM E. TAYLOR, Ph.D.

NOVEMBER 29, 1999

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION

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**
	)	
PETITION OF US WEST COMMUNICATIONS, INC FOR FORBEARANCE FROM REGULATION AS A DOMINANT CARRIER IN THE PHOENIX, ARIZONA MSA	)	**CC DOCKET No. 98-157**

REPLY COMMENTS OF

WILLIAM E. TAYLOR, Ph.D.

ON BEHALF OF

UNITED STATES TELEPHONE ASSOCIATION

NOVEMBER 29, 1999

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Consulting Economists

REPLY COMMENTS OF
WILLIAM E. TAYLOR, Ph.D.

CC DOCKET NO. 96-262

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REPLY COMMENTS OF WILLIAM E. TAYLOR, PH.D.
NOVEMBER 29, 1999

I. INTRODUCTION

1. My name is William E. Taylor. I am a Senior Vice President of National Economic Research Associates, Inc. (NERA), head of its telecommunications economics practice and head of its Cambridge office. I filed direct comments in this Docket on behalf of the United States Telephone Association ("USTA") on October 29, 1999 and have been asked to reply to some of the economic issues raised by other parties: in particular, the claims

- that Phase II relief should be primarily dependent on a market share test: AT&T has proposed that relief not be granted until 50% of subscriber locations in the MSA are served by alternate facilities-based providers,
- that the mere offering of access services by competitors is inadequate evidence to demonstrate the existence of competition,
- that the Commission should add a q factor to the Traffic-Sensitive price cap index ("PCI") and that it should be based on the growth of minutes, and
- that the Commission should replace the "g/2" component of the price cap formula with "g".

Sound economic analysis shows that none of these proposals will result in benefits to customers.

II. PRICING FLEXIBILITY SHOULD NOT BE BASED ON MARKET SHARE TESTS

2. Several parties have argued that the primary criterion for obtaining Phase II pricing flexibility should be a market share test. AT&T (at 10) states, "Such competitive services must be available to 75% of subscriber locations in the MSA, and 50% of subscriber locations in the MSA must actually be served by such alternate facilities-based providers rather than the LEC." Time Warner Telecom (at 25-26) states, "Specifically, the Phase II flexibility should be triggered only upon a demonstration that switched services are offered to 75% of customer locations by competitors over their own facilities, and that service is actually provided to 15%

of customer locations by competitors over their own facilities." In addition, Time Warner Telecom argues that the mere offering of access services is insufficient to demonstrate the existence of competition in the exchange access market, claiming (at 25) that

> [t]he Commission should not make this already dangerous situation worse by adopting an overly lenient trigger for Phase II relief for common line and switching. For example, the mere offering of service is, by itself, inadequate evidence that competitors can actually compete effectively with the ILEC.

3. These positions are entirely inconsistent with the standard economic principles that are used to determine whether a firm possesses undue market power in a relevant economic market and has the ability to price above competitive levels for a sustained period of time. The Commission should reject these proposals because conditioning relief on market share tests does not reflect the ILEC's ability to price above competitive levels for a sustained period of time. That is, the proposals are not based on a measure of market power, and the end result of adopting these criteria would be a reduction in economic welfare because consumers would be denied lower prices. The presence of competitors in a relevant economic market offering to provide services to the public indicates that barriers to entering and expanding in the relevant market are not prohibitive, and that presence has the effect of disciplining the pricing behavior of the dominant firm.[1] Moreover, the measure of concentration proposed by AT&T and Time Warner is particularly flawed because it is based on relative shares of customer locations rather than capacity. Indeed, AT&T's position on the proper use of market shares in the current proceeding is contrary to and inconsistent with previous positions it has taken when the market power in question was its own.

4. Economic theory teaches that market share by itself is not a good predictor of the ability to price above competitive levels for a sustained period of time (i.e., whether a firm has undue market power). Particularly in dynamic markets newly opened to competition, structural measures of industry concentration are necessarily backward-looking and have little effect on future pricing behavior in the market. The fundamental source of market power is a firm's

[1] Indeed, in FCC 99-206, ¶ 80, the Commission explains how investment in facilities by CLECs, which tend to have high sunk costs and low variable costs, disciplines the pricing behavior of ILECs. The implication is that capacity, not volumes are much more competitively significant.

price elasticity of demand which, in turn, depends not only on market share, but on other economic factors such as the market price elasticity of demand, the elasticity of supply, and, most importantly, the extent of barriers to entering and expanding in a market. Rather than depending on a market share test to determine Phase II flexibility, the Commission should concentrate on measuring barriers to entering and expanding production in the relevant economic markets.

5. Contrary to the position of Time Warner Telecom and AT&T, the fact that CLECs are offering to provide competing access services is an important piece of evidence regarding whether ILECs possess market power and can price above the competitive level. This is so because the mere offering to provide competing access service to customers provides important information on the two key sources of competition in markets—existing firms and potential entrants.

6. The fact that CLECs are offering (through RFPs, marketing campaigns, etc) to provide service to customers currently served by the ILEC indicates that supply is sufficiently elastic to constrain—to some degree—the ILEC's unilateral pricing decisions. A new competitor is particularly keen to ensure that it provides good service—i.e., competitive prices, high quality and good customer support services. A new competitor to the market would not hold itself out to the public to offer service unless it was reasonably assured that it had the capacity and infrastructure to fulfill the request within a reasonable period of time. Not being able to meet the request would jeopardize its reputation and weaken its position in the market. If CLECs are credibly offering to provide service to ILEC customers at current prices, they would clearly have the ability and a greater incentive to offer access services to the same customers if the ILEC raised prices above the competitive level. Any attempt by the ILEC to increase price above the competitive level would be met by an increase in CLECs' supply which would make the price increase less profitable. As such, contrary to the position of the intervenors in this case, the Commission should use the fact that CLECs are offering to provide service to customers in an MSA as evidence that competition exists in the market.

7. Second, the fact that CLECs have entered a particular market, are serving customers and are offering to provide service to additional customers indicates that barriers to entering and