SLCs. Once the PICC and the CCL are phased out, the remaining ILEC rates for switching and transport will be low – half a cent per minute on average – and the absolute variation in these rates across price cap carriers' serving areas will also be less. The result is that access rates will be more similar from region to region than they are now. Therefore, IXCs will, if anything, feel less pressure to "deaverage interstate interexchange service rates in a manner that conflicts with Sections 254(g)."[22]

### 2. MCI's claim that an ILEC must provide a UNE platform before it is allowed to deaverage is both unnecessary and anticompetitive

MCI also asks the Commission to restrict access to geographic deaveraging of common line rates only to a price cap LEC that provides a "UNE platform" throughout its service area.[23] MCI believes that a UNE platform is required to "prevent price cap LECs from increasing geographically-deaveraged interstate access rates to unreasonable levels, particularly in areas where competition would otherwise develop more slowly."[24] This is a red herring that the Commission need not address here.

First, the entire question of UNE platforms is unrelated to this proceeding.[25] Here, the Commission is addressing geographic deaveraging of common line rates, not assembly of unbundled network elements.

---

22 *FNPRM*, at n. 493.

23 MCI at 4.

24 *Id.*

25 The Commission has dealt with this issue in a separate proceeding. *See*
(Continued...)

Moreover, ILECs never have been required to provide a UNE platform. On the contrary, the Commission has concluded that ILECs do not have to assemble already disassembled elements. Accordingly, MCI's request should be denied.

### 3. Contrary to AT&T, there is no need to wait until the CCL, PICC and flow-back are eliminated before allowing ILECs to deaverage common line rates

AT&T has asked the Commission to forestall ILEC deaveraging until such a time when the CCL, PICCs, and ILEC Flowback have been eliminated from carrier access charges.[26] AT&T argues that the CCL, PICC and flow-back represent implicit subsidies flowing from IXCs to ILECs. However, AT&T has provided no rationale to explain why these elements must be removed as a prerequisite to geographic deaveraging, and its request should, therefore, be denied.

As GTE stated in its opening comments, the Commission should avoid any prerequisites that would prevent ILECs from implementing geographic deaveraging because it would only delay bringing significant benefits to consumers. All participants in this proceeding, including the IXCs, stand to benefit because geographic deaveraging results in access prices that are more closely aligned with costs.

---

(...Continued)

*Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, FCC 99-238 (Third Report and Order and Fourth Further Notice of Proposed Rulemaking) (rel. Nov. 5, 1999).

[26] AT&T at 3-4.

Geographic deaveraging is a cost-based solution to access charge problems. There is no need to eliminate the CCL and the PICC before allowing geographic deaveraging because deaveraging works as effectively with multiple cost elements as well as it does with a single element.

Furthermore, flow back is the result of a LEC's efforts to recover universal service fund contributions. Because it is a recovery mechanism for a specific element of LEC costs and only affects over all common line revenues it should have no effect on deaveraging common line costs in general. Rather, as long as the flow back mechanism is appropriate, deaveraging rates should not depend on the fact that USF cost recovery is included in the rates. Thus, AT&T's proposed condition should be rejected.

While GTE does not agree with AT&T's claim that removal of the CCL, PICC, and flow-back should be a prerequisite to geographic deaveraging, it notes that under the CALLS proposal, there is a "cascade" in which revenues generated by the realignment of SLCs, and by the new universal service fund, are applied first toward eliminating the CCL and PICC, and then toward SLC deaveraging.[27] In addition, the CALLS plan would eliminate the flow-back from ILEC access rates. Accordingly, if the CALLS proposal is adopted in full, AT&T's concerns are addressed. In either case,

---

[27] However, the CALLS plan does not establish elimination of the CCL and PICC as a prerequisite for SLC deaveraging, since participating ILECs are free to make voluntary reductions in any zoned SLC at any time.

elimination of those cost elements should not be a prerequisite to geographic deaveraging.

### C. The Universal Service Cost Model Has Not Been Designed For, And Is Therefore Not Useful In, Determining Common Line Pricing

Contrary to AT&T's suggestion,[28] the universal service cost model is not an acceptable mechanism for determining common line pricing. In fact, the Commission has previously determined in other contexts that the cost model should not be used at instances such as this proceeding.

As the Commission carefully noted in its *Ninth Report and Order*[29] in the universal service proceeding, "the federal cost model was developed for the purpose of determining federal universal service support . . . ."[30] The agency specifically rejected suggestions that it be used in other contexts, concluding that the model "may not be appropriate for other purposes, such as determining prices for unbundled network elements." It also expressly stated that it "has not considered the appropriateness of this model for any other purposes . . . ."[31]

---

28 "The Commission's forward-looking cost proxy model that is being developed in the Universal Service proceedings, CC Dockets 96-45 and 97-160, should be modified as appropriate and used to develop common line costs for the UNE zones in a study area." AT&T at 6.

29 *Federal State Board on Universal Service*, FCC 99-306 (Ninth Report and Order and Eighteenth Order on Reconsideration) (rel. Nov. 2, 1999).

30 *Id.* at ¶ 41.

31 *Id.*

Indeed, perhaps anticipating an argument such as has been made here, the Commission "cautioned parties from making any claims in other proceedings based upon the input values adopted in the *Input Order*."[32] This remains sound advice. Accordingly, the Commission's conclusions regarding the cost model make it evident that the model should not be used as a basis for making any determinations in this proceeding.

### D. Carriers Should Be Allowed, But Not Required, To Deaverage The Switching Rate Structure

The Commission has previously recognized that switching costs differ among carriers. If carriers are allowed to geographically deaverage switching prices along with common line prices, they will more closely reflect costs. GTE supports Sprint's analysis that shows such cost differences.[33] GTE's cost estimates indicate that the per-minute cost of local switching does vary by geographic area, primarily because of differences in the size of local switches that can economically be deployed in areas of differing density.

As GTE argued in its opening comments, geographic deaveraging should result in better price signals to encourage economic investment in local switching facilities. As arbitrage opportunities disappear, competitors will abandon uneconomic decisions that are based on inaccurate market information. Further, facilities-based entry to the

---

[32] *Id.*

[33] Comments of Sprint Corporation at 12-13 ("Sprint").

market will become a more attractive economic decision. This will advance the Commission's goal of establishing facilities-based competition in the market for local telephone service.

## II. IF THE FCC SETS PHASE II TRIGGERS FOR COMMON LINE AND TRAFFIC-SENSITIVE SERVICES TOO HIGH, COMPETITION WILL BE UNDERMINED AND CONSUMERS WILL BE HARMED

In its opening comments, GTE explained why the Commission should set realistic "triggers" for Phase II pricing relief for common line and traffic-sensitive services. The Commission should reject proposals by other commenters that the agency introduce regulatory uncertainty by postponing setting triggers until some unknown future date, or that it set such excessively high triggers as to be practically unachievable, thereby harming both consumers and competition.

### A. Phase II Triggers Should Be Adopted Now So That Regulatory Lag Does Not Undermine Competition

It would be both harmful and unrealistic for the Commission to accept the suggestion of several commenters that the FCC adopt a "do nothing" attitude towards implementing Phase II triggers for common line and traffic-sensitive services.[34] While opponents suggest that the issue is somehow not yet ripe for consideration,[35] or can

---

[34] Comments of Cable and Wireless USA, Inc. ("C&W") at 7-8; Comments of Competitive Telecommunications Association at 8-9 ("CompTel"); MCI at 7-9; Sprint at 8.

[35] Comments of C&W at 7.

only be contemplated after extensive study of the impact of Phase I relief,[36] they provide no rationale for further delay. Stripped of their rhetoric, the real purpose of such stalling tactics is clear – to maintain for as long as possible regulatory barriers that prevent incumbents from providing services at prices that match their competitors. Not surprisingly, the same parties who support such a stalling maneuver are those most likely to benefit from forcing ILECs to employ artificially inflated pricing.

In the past, the Commission has wisely established in advance a framework for predicting future pricing models and the benefits that it provides to incumbents and competitors alike. For incumbents, completing work on Phase II triggers now will provide a clear guidance on which to proceed with market entry decisions and investment commitments. For competitors, the completion of Phase II triggers will offer certainty for them to predict when pricing flexibility will be forthcoming.[37] Interim measures will not resolve these uncertainties. The Commission should not tolerate

---

36 C&W at 6, CompTel at 9.

37 In an analysis presented to the Commission in an earlier access reform proceeding, Mark Schankerman described carriers' decisions to enter and invest in telecommunications market as a two-stage game. In the first stage, firms made their entry and investment decisions; in the second stage, they competed on the basis of price, quality, and other factors. The crucial point in Schankerman's analysis is that firm's decisions in the first stage will be based on their expectations concerning the regulatory rules in the second stage. Therefore, the Commission should make clear now what those rules will be. This will allow firms to make better investment and entry decisions today – even in markets where the triggers have not yet been met. *See Competition Through Regulatory Symmetry,* Statement of Dr. Mark Schankerman, attachment to GTE's comments in CC Docket 94-1, filed May 9, 1994.

efforts by such parties to delay the prospect of competing with market-responsive ILEC prices.

Instead, the Commission should act now to establish a unified approach to pricing flexibility by finalizing the Phase II framework in *this* proceeding. As the Commission itself recognized in implementing Phase II triggers for special access services and dedicated transport, "retaining regulations longer than necessary is contrary to the public interest."[38] That principle applies equally here; the Commission should move ahead now with the setting of Phase II triggers in order to avoid the inherently harmful effects of regulatory lag and provide consumers with the greatest amount of choice among competitively priced services in the most timely manner possible.

### B. Proposals To Require Market Share Test And 75 Percent Coverage Prior To Granting Phase II Flexibility Is Unreasonably Stringent And Anticompetitive

GTE and others support the Commission's proposal to establish Phase II triggers for common line and traffic-sensitive services that mirror the Phase II triggers adopted for special access services and dedicated transport in the *Fifth Report and Order*. This standard would grant Phase II relief where "competitors, in aggregate, offer service to at least 50 percent of the customer locations in an MSA."[39]

---

38 *Fifth Report and Order*, ¶144.

39 GTE at 22; Comments of Bell Atlantic at 21-22; BellSouth at 6; SBC at 2; USTA at 9-10.

For their part, AT&T and Time Warner Telecommunications ("TWT") have suggested alternative triggers that would incorporate a higher service-area threshold and add a new market-share test. They propose that incumbents be required to show that competitive services are available to 75 percent of subscriber locations in an MSA and that 50 percent of subscriber locations are served by alternative facilities-based providers before price cap relief would be available.[40] Nothing in their comments, however, justifies either a different threshold than already established in the *Fifth Report and Order* or the use of market share to determine eligibility for relief. As shown herein, and in the response of Dr. William Taylor attached to the reply comments being filed concurrently by the United States Telecom Association, these proposals are wholly unjustified.

**1. The analysis used to eliminate price caps for AT&T is would not be useful for ILEC pricing flexibility**

AT&T and TWT draw their proposed higher triggers for Phase II ILEC pricing from measures applied to AT&T in its non-dominance proceeding.[41] That proceeding is easily distinguished.

First, the AT&T non-dominance proceeding is inapposite to the facts present here. In that proceeding, the Commission sought to apply myriad factors to a single, national, geographic area. Here, each ILEC faces a different market in a different

---

40 AT&T at 10; Comments of Time Warner Telecom at 25-26 ("TWT").

41 AT&T at 9; TWT at 25-26.

region. Thus, the agency will need to consider the triggers time and again across a mosaic of local markets. Under such circumstances, the need for administrative manageability requires a scheme dependent on easily-determined indicators, not complex factors.

Second, the test applied to AT&T in the interexchange non-dominance proceeding involved a time-consuming and resource-intensive process that is unwarranted for determining whether an ILEC satisfies the Phase II triggers for common line and traffic-sensitive access services. To engage in such a review would require further proceedings each time an ILEC seeks Phase II relief in its region, delaying still further – and increasing the cost of -- a process that has already consumed more than three years. Neither the Commission or the ILECs should be forced to wade through such a regulatory quagmire.

In the *Fifth Report and Order*, the Commission established triggers for Phase II relief that are based on a clearly determinable fact – whether or not consumers have access to competitors in a particular market. The thresholds approved by the Commission protect consumers by guaranteeing the presence of competition prior to price cap relief. The triggers also ensure that the process would be swift and predictable, which will promise to speed new services and most competitive prices to consumers.

Neither AT&T or TWT justify creating Phase II triggers that are inconsistent with the standard established in the *Fifth Report and Order.* As noted below, their proposal would undoubtedly contribute to regulatory lag and ultimately forestall incumbents from providing consumers with the optimal choice and lowest possible prices.

### 2. Actual market share data does not accurately reflect the constraining effect that market forces have on ILEC pricing

AT&T and TWT suggest that the mere "offering" of access services by CLECs to 50 percent of the subscriber locations is insufficient as a basis for providing Phase II price cap relief to incumbents.[42] Instead, they propose that the Commission establish triggers that require: (1) that competitive services be available to 75 percent of the subscriber locations in an MSA: and (2) that an alternative facilities-based provider must actually serve 50 percent of the subscriber locations in an MSA. GTE objects to these measures, which amount to "overkill" devices designed solely to prevent ILECs from gaining timely price cap relief and providing the maximum competitive options and price benefits to consumers.

As an initial matter, the Commission should reject as arbitrary the suggestion that the Phase II triggers should require that competitive services be available to 75 percent of the subscriber locations in an MSA. The parties have provided no rationale for setting the threshold at this level. Nor have they demonstrated that the triggers set in the *Fifth Report and Order* would fail to ensure that competition exists sufficiently to justify providing an ILEC relief from price caps. Moreover, they have offered no evidence suggesting that requiring more than 50 percent of an MSA's subscriber

---

42 AT&T at 10, TWT at 25-26.

locations to have access to alternative providers of common line and traffic sensitive services is insufficient to "absorb substantial amounts of the LEC's business in the event of a small but significant non-transitory price increase."[43]

Insofar as AT&T and TWT suggest that the Commission should add a market share test to the requirements of the Phase II triggers, such a measure is unwarranted. As Dr. William Taylor points out in his submission attached to the reply comments of the USTA, it is not market share that will dictate an ILEC's pricing behavior, but rather whether competitors have the means to deploy infrastructure in a timely and sufficient fashion to discipline ILECs' pricing.[44] It is the presence of competitors' facilities (CLE deployment) and their ability to provide service that force incumbents to price their services competitively. This is especially true where, as here, the incumbent traditionally has been subjected to extensive economic regulation. As Dr. Taylor states, "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."[45] AT&T itself, when it served its interests, has consistently

---

43 AT&T at 10.

44 *See* Reply Comments of William E. Taylor, Ph.D., on behalf of USTA ("Taylor Reply"), CC Docket No. 96-262 (filed Nov. 29, 1999).

45 *See* Taylor Reply.

argued against the use of market-share measurements in its own attempts to break free from price cap regulation in the interexchange market.[46]

It is significant that the Commission never adopted a specific market share trigger in evaluating AT&T's market power in long distance, focusing instead on indicators of the elasticity of demand and supply.[47] The triggers in the *Fifth Report and Order* will serve as reasonable indicators of the elasticity of alternative supply, and are therefore entirely consistent with the economic reasoning the Commission has previously applied to AT&T.

Furthermore, the market share test advocated by AT&T and TWT also provides ample opportunity for abuse, the kind of "gaming" of the system that the Commission explicitly sought to avoid in its consideration of Phase II triggers for special access services and dedicated transport.[48] Removing the effect of potential competition from the analysis that determines Phase II relief would create a "moral hazard" because CLECs – by deciding which customers to serve and not to serve in an MSA – will have the ability to determine the timing of ILEC pricing flexibility. By implementing triggers for common line and traffic-sensitive services identical to those which have already been

---

[46] *See, e.g., Competition in the Interstate Interexchange Marketplace*, 6 FCC Rcd 5880, 5882 (Report and Order) (1991) *("Competition Order")*.

[47] *See, e.g., Competition Order,* 6 FCC Rcd 5886-87.

[48] *Fifth Report and Order,* ¶143. *See* Taylor Reply.

adopted for special access services and dedicated transport, the prospect of such gamesmanship is prevented.

### C. Wireless Customers Should Be Considered In Determining Phase II Triggers

Sprint and AT&T – two of the nation's largest providers of wireless PCS services – seek to downplay their own services for regulatory purposes by urging that wireless services continue to be excluded from consideration in setting Phase II triggers.[49] In their opening comments, GTE and others pointed out that the exclusion of wireless customers from the calculation of triggers for Phase II relief in the *Fifth Report and Order* is unfounded. There is no reason to doubt that facilities-based wireless and broadband alternatives to the loop already exist and are becoming more available every day, and Sprint and AT&T provide no valid support for their continued exclusion.

It is a fact of telecommunications today that, driven by rapidly decreasing prices and expanding service areas, wireless customers can and do access voice services more easily than ever. Many customers use wireless as an alternative to wired loop services for both voice and data services. Consequently, these services should be included in the Commission determination of Phase II triggers.

---

[49] Sprint at 9; AT&T at 10-11.

## D. There Is No Justification For Establishing Special Conditions Once Phase II Triggers Have Been Met

AT&T suggests that special constraints on common line rates are necessary, even once Phase II triggers have been met. This proposal is unnecessary, and should not be adopted. The current Federal high cost funds – including the new nonrural fund recently adopted by the commission – are unrelated to access charges, but instead are used to maintain the reasonable comparability of intrastate rates. There is thus no need to constrain federal access charges to preclude over-recovery of costs supported by the current high cost fund.

While interstate access charges today do generate implicit subsidies, the Commission has yet to adopt any explicit universal service mechanism to replace those implicit subsidies. The CALLS plan includes a new $650 million universal service fund for that purpose. This would make possible a cap of $7 for single-line SLCs, and $9.20 for multiline business SLCs. If CALLS is adopted, the concern raised by AT&T would thus be addressed by the caps in that plan, and by market forces in areas where Phase II triggers have been met.

If CALLS is not adopted, the Commission must nonetheless replace the current implicit subsidies in interstate access with explicit, portable universal service support. If this is done correctly, then caps on SLCs will be unnecessary in areas where Phase II triggers have been met. In those areas, market forces are sufficient to constrain ILEC common line rates to their market levels. To maintain affordable SLCs in higher cost zones, the FCC must provide support for the difference between the market rate and whatever rate the Commission finds to be affordable. If market forces are sufficient to constrain rates to market levels, then they will also be sufficient to constrain them to affordable levels, net of the support. Because the fund is portable, there is no competitive problem created by this explicit support.[50] For these reasons there will be no need for any additional price constraint on SLCs in areas where Phase II triggers have been met, regardless of whether universal service funding is made available in that area.

## III. THE RECORD OVERWHELMINGLY OPPOSES A MANDATORY RESTRUCTURING OF SWITCHING CHARGES

The Commission's ill-conceived proposal to mandate a fundamental restructuring of switching charges to a capacity-based structure received overwhelming opposition. In a rare show of unanimity, IXCs,[51] CLECs,[52] as well as other ILECs, all opposed this proposal.[53]

---

[50] As GTE has previously pointed out, the market might not constrain the pricing of any particular carrier to affordable levels if carriers can target certain customers with bundles of service. *Texas Office of Public Utilities V. FCC*, 183 F.3d 393, 419 (5th Cir. 1999). However, the Commission has assured the Fifth Circuit court that it will take effective measures to prevent bundling from being used in this manner. *Id.* at 420.

[51] AT&T at 12-13; MCI at 10-12; Sprint at 11-13.

[52] C&W at 5-6; Comments of Focal Communications and Hyperion Telecommunications, Inc. at 2-4; TWT at 32-34.

[53] Bell Atlantic at 1-4; BellSouth at 7-8; SBC at 2-3; Comments of US West at 8-15 ("US West").

Many commenters agreed with GTE that mandating converting switching rates to a capacity-based structure would simply not improve the economic performance of the system as the Commission appears to have believed.[54] For example, USTA correctly observed that there is no basis on which to believe that peak pricing for access customers would necessarily lead to peak pricing for end users, because "access charges are just one input that makes up long distance prices."[55] Similarly, Bell Atlantic noted that capacity-based pricing is cost effective only if "it shifts traffic to off-peak periods, so that additional usage does not require additional switch capacity."[56] However, the peak usage for each individual access customer may not coincide with the peak for all traffic at the switch.[57]

Other commenters simply pointed out that Commission action at this time would be premature. For instance, AT&T noted that the current rate structure is reasonably cost-based and has only been in effect since January 1998. Given this short experience, AT&T correctly concluded that "it would be premature to abandon [the current system] without solid evidence that a new structure could be implemented that

---

[54] Bell Atlantic at 4; USTA at 10-15; US West at 8-14.

[55] USTA at 14.

[56] Bell Atlantic at 4. See also AT&T at 15: "The number of trunks purchased by and IXC, however, is not necessarily a good proxy for the amount of switching capacity required during peak periods. IXCs order trunks based on their own peak period traffic, while the amount of switching capacity required depends on overall traffic during the LEC's peak period, of which IXC access traffic is only a small portion."

[57] *Id.*

would be more efficient."[58] Likewise, Cable & Wireless noted that the proposal was premature given that the scope and implications of the capacity-based switching proposal are not clear at this time.[59]

Only two commenters, both end-users, spoke in favor of capacity-based pricing.[60] However, neither one provided any additional evidence or reasoning why mandatory capacity based pricing would be in the public interest.[61]

Ad Hoc contends that the capacity-based proposal is more accurate than the current MOU pricing.[62] This, however, fails to recognize that the *FNPRM*'s proposal simply employs a different unit (trunks) as a *proxy* to measure the relative demand each

---

58 AT&T at 13.

59 C&W at 5.

60 Comments of the Ad Hoc Telecommunications Users Committee ("Ad Hoc") at 14-15; Comments of General Services Administration ("GSA") at 9.

61 GSA merely makes an unsupported statement that capacity-based pricing is the most economically correct pricing mechanism. *See* GSA at 9.

62 Ad Hoc at 9-11. Ad Hoc also states "that certain ILECs (notably, GTE and Sprint) used their pricing flexibility under the price caps system to eliminate the flat-rated trunk port charges established in the *Access Reform First Report and Order*" in an attempt to manipulate the system. Ad Hoc Comments at 13 (citing *FNPRM*, ¶ 234, n.564). While GTE has eliminated its trunk port charges in Northern California and Minnesota (the exchanges in Montana and Arizona have been sold), this action is a result of an anomaly of the price cap rules. The end office switching rates as well as all other revenue-producing rate elements in the Traffic Sensitive basket have been eliminated because in small tariff jurisdictions the rules cause price cap indices (PCIs) to become negative. Negative indices require zero rates so that revenue will not be generated. Therefore, GTE's elimination of port charges is in no way an attempt to manipulate the system. Moreover, reorganization of the baskets and bands would further complicate the situation and should not be undertaken by the Commission.

customer places on the switch. The Commission's proposal is no more accurate at capturing the true cost-capacity relationship than MOU pricing, particularly in view of the fact that peak demand is driven by the independent actions of a large number of players.[63] In fact, Ad Hoc's view simply fails to appreciate that MOU pricing is an accurate means to recover switching costs because major components of switching do exhaust with minutes of use.[64]

Rather than generating the public interest benefits that Ad Hoc and GSA hope to see, mandating capacity-based pricing is far more likely actually to injure the public interest. As GTE noted in its comments, capacity-based charges could result in traffic actually being moved to the peak busy hour of the switch, resulting in even higher peak loads on the switch and lower off-peak loads.[65] Raising an additional legitimate concern, USTA found that "any potential gain from a capacity-based rate structure

---

63 AT&T states that "it is not clear that payments associated with trunk-based charges would differ much from those based on existing per-minute charges." AT&T documents this with data that indicate that "growth in trunk ports tends to coincide closely with the growth in local switching minutes." AT&T at 15.

64 USTA is submitting an economic study that examines the nature of telecommunications switching costs. The study concludes that there are significant local switching costs that are caused by minutes because these factors do use up capacity of major switching components (such as the switching matrix) and will drive investment decisions. *See* Comments of Brian Delidow and Steve Parsons, Attachment to USTA Reply Comments, at ¶¶ 2 & 16-18.

65 GTE at 31-32.

would be offset by implementation costs" because the "information requirements" needed to implement such a system "would be significant."[66]

In addition, U S West identified yet another potential problem in the form of the undesirable arbitrage opportunity that capacity-based pricing would create. Under capacity pricing, IXCs would have an incentive to game the system through moving traffic between dedicated and tandem switches.[67] Rather than moving traffic to dedicated facilities, which has the effect of making switch use predictable and more certain, the IXCs would have an incentive to "hide" traffic in shared facilities, which would make switch planning more difficult. By creating this perverse incentive, capacity-based pricing would present a new danger that ILECs would make uneconomic switching investments.

In sum, the record provides no basis for the Commission to mandate that ILECs abruptly convert their switching prices to capacity-based charges. The theoretical benefits are illusory, and the changes too soon on the heels of the last changes the FCC mandated. Simply put, the Commission should not be devoting its resources to tinkering still more with a pricing system that before long will be a vestige of the past.

---

[66] USTA Comment at 13; *see also* MCI at 11 ("It is doubtful that the new rate structure provides sufficient benefits to outweigh implementation costs").

[67] U S West at 12-14. The extent of this incentive depends on how the Commission deals with the problem of how to set the relative price of tandem-switched traffic versus direct traffic under a capacity-based system. Per-trunk charges could be imposed on trunk terminations at the tandem, but it is not clear how to set the level of these charges, which would recover costs of tandem switching as well as end office switching.

At the same time, while the Commission should not mandate that ILECs use capacity-based switching charges, there would appear to be no reason to deny ILECs the flexibility to do so where cost-causation or market factors dictate.[68] Rather than attempt at this late date to prescribe a new access structure, the Commission should instead implement the CALLS proposal, which would reduce the average level of GTE's local switching charges to a quarter of a cent per minute. The Commission should also remove the current Part 69 rate structure requirements for switching, so that, once switching rates have reached the low level produced by CALLS, ILECs would be free to implement more efficient new structures.

## IV. THE COMMISSION'S Q FACTOR AND ACCOMPANYING REINITIALIZATION PROPOSAL WOULD VIOLATE PRICE CAP PRINCIPLES, PARTICULARLY IF SWITCHING PRICES ARE NOT RESTRUCTURED

GTE's opening comments explained the deficiencies in the *FNPRM*'s proposal to introduce a "q" factor in conjunction with the its capacity-based charge proposal in order to prevent ILECs from earning alleged "windfall" profits. As GTE and others explained,

---

[68] The FCC should reject MCI's dated and redundant proposal to prescribe, by regulatory mandate, lower access charges. *See* MCI at 12-15. As the Commission is well aware, prescriptive approaches will (1) stall the continued development of actual competition in the access market, (2) undermine the benefits of the existing price cap rules, and (3) lead to an illegal taking. Justifiably, the Commission has consistently rejected to adopt such far-reaching and intrusive schemes, *see, e.g., Access Charge Reform,* 12 FCC Rcd 15982, 16097 (First Report and Order) (1997), and is justified in doing so again in this proceeding. Rather, market based policies represent the preferred means of accomplishing the Commission's public interest goals. *See id.* 12 FCC Rcd at 16601 (noting that competition itself "will, in most cases, better serve the public interest").

the X-factor in the current price cap regime already accounts for growth in local switching minutes per unit of capacity. Introducing a "q" factor would, therefore, unjustifiably double-count ILEC productivity's.

Seizing upon the original misguided proposal, AT&T proposes adding a "q" factor to the Commission's Price Cap Index ("PCI") formula even if the Commission does *not* mandate a shift to capacity-based switching charges.[69] AT&T claims that the addition of a "q" factor is required even under *current* price structures to account for purported LEC windfalls gained from the current interstate pricing rules.[70] AT&T asserts that these alleged windfalls arise from a purported imbalance between costs driven by non-traffic-sensitive factors and revenues collected on a traffic-sensitive basis and are unaccounted for in the Commission's present pricing calculations, including the X-Factor. This proposal is unnecessary, duplicative, and should be rejected.

First, AT&T does not demonstrate any basis for concluding that the per-minute recovery of switching costs leads to any mismatch between switching costs and revenues. Indeed, AT&T is inconsistent on this point. In arguing to reject the Commission's proposed capacity-based charge, AT&T says that "the current rate structure for local switching is reasonably cost-based."[71] Yet five pages later AT&T asserts that the current per-minute structure is <u>not</u> cost-based, because the costs of

---

69 AT&T at 17.

70 *Id.* at 17-18.

71 *Id.* at 12.

switching "tend not to increase with growth in traffic."[72] In an appendix, AT&T suggests that perhaps the cost of providing local switching for interstate access is a function of the number of switches nationwide.[73] Yet AT&T does not suggest that the structure of switching charges should be changed to reflect these cost "concepts." AT&T's "q" proposal appears to be based not on any consistent concept of how costs are incurred, but rather on a desire to make an arbitrary downward adjustment in ILEC revenues.

In fact, it is clear that the costs of shared switch resources do vary with usage. While forward-looking cost models have generally produced results that are unreliable, they all agree – including AT&T's model – that switching costs vary with usage.[74] AT&T's only evidence to the contrary is based on ARMIS data on the expenses and investments allocated to the interstate switching category.[75] As GTE explained in its comments, these allocations reveal more about the separations process – and the

---

72 *Id.* at 18.

73 *Id.* at Attachment E.

74 It is true that, as the demand for switching grows, switching costs do not expand proportionately. This simple means that there are economies of scale in switching, as there are in most telecommunications services. As will be discussed below, the calculation of the X factor already captures any productivity gains from these scale economies, and there is no need for a second "q" adjustment. Indeed, since most telecommunications outputs are subject to scale economies, if AT&T's argument were correct, the commission would need a separate adjustment for every service the ILECs produce, which would call into question the entire validity of the commission's approach to setting X. In fact, the opposite is true: there should not be any service-specific adjustments.

75 *Id.* at 18.

growth of Internet minutes, which are still counted as intrastate for separations purposes – than they do about the cost of local switching.[76]

Second, in any event, it does not matter whether, or to what extent, switching costs vary with usage. As GTE's opening comments explained, no q factor is warranted because the X-factor in the current price cap system *already* prevents the kind of windfall that the *FNPRM* feared and that AT&T (erroneously) says now exists. This is true because, since 1997 the Commission has selected the X-factor using a direct measure of Total Factor Productivity that takes into account the growth in outputs that AT&T mistakenly believes gives rise to a mismatch. In fact, as Dr. Gollop shows in his attachment to the reply comments of USTA: "under the price cap X-factor," the growth in switched access minutes is explicitly incorporated into the measure of LEC output growth and thereby enters directly into the calculation of LEC TFP growth."[77] Therefore, "since an increase in switched access minutes automatically raises X in the Commission's current model, any additional "q" factor adjustment (as proposed by AT&T) for that <u>same</u> growth necessarily results in double-counting."[78] Therefore,

---

[76] GTE at 43. *See* Taylor Reply. Professor Gallop, on behalf of USTA, shows that, while the allocated rate based cited by AT&T declined during the period, the more relevant measure of capital used by the commission in its X-factor model increased over the same period. This more relevant measure was adopted in 1997, based on a methodology proposed by AT&T.

[77] *See* Reply Comments of Frank M. Gollop, on behalf of USTA ("Gollop Reply"), CC Docket No. 96-262 (filed Nov. 29, 1999).

[78] *See* Gollop Reply.

adding a "q" factor would merely create a punitive "double counting," arising from an inherently downward-biased PCI.[79]

Third, there is no credible evidence that there is any "windfall" which might justify the correction in the PCI that AT&T seeks. Dr. Gollop shows that the benefits of ILECs' productivity performance have for many years been transferred to the IXC customers. As such, "[t]he price of a representative unit of interstate service decreased by 37% between 1990 and 1998."[80] This compares quite favorably to the 10.5% *increase* in output prices in the non-farm business sector during this period. The 47.5 percent spread between these measures is a direct consequence of the Commission's X-Factor policy, and illustrates the absence of any "windfall". Further, the earnings of price cap ILECs during this period grew at less than half the rate observed for a broad index of U.S. firms, the Value Line U.S. industrials. ILEC earnings per unit of output declined 6.2% during the period, while comparable earnings of the Value Line firms increased by 33%.

And, as Dr. Taylor points out in his reply comments submitted on behalf of USTA, "the argument that the agent that causes output growth is somehow entitled to its benefits has no basis in economics."[81] ILECs are entitled to the benefits flowing from the services that they provide. Indeed, if there is any factor that has contributed most to

---

79 *Id.*

80 *Id.*

81 *See* Taylor Reply.

the growth in long distance demand, it is reduction in long distance prices, which in turn is entirely explained by reductions in access prices. But it is inappropriate for the Commission to attribute growth to any carrier, or to attempt to confer benefits based on claims that one carrier or another has promoted growth. As discussed above, the price cap mechanism already captures the full effect of growth in any output. AT&T has failed to make the case to justify any further adjustment in the form of a "q" factor.

## V. THE FCC SHOULD REJECT A "FULL g" BECAUSE IT IS WRONG IN CONCEPT AND NOT NECESSARY THIS LATE IN THE GAME

Parties split predictably over whether the commission should modify the price cap carrier common line formula to go to a "full g". Unsurprisingly, IXCs and end users favor a full "g".[82] These parties argue that full credit should be given to IXCs on the basis of their view that they alone were responsible for demand increases, not ILECs. Other parties strongly counter that the g factor should be eliminated altogether because the X factor already accounts for demand growth.[83]

The FCC should reject the arguments that call for a full "g" for three reasons. First, the FCC has already addressed and answered this question on two prior occasions and concluded that g/2 struck the correct balance between ILEC and IXC interests.[84] The IXCs provide nothing new to justify a different conclusion now.

---

[82] Ad Hoc at 3-6; MCI at 16.

[83] Bell Atlantic at 15-17; SBC at 3.

[84] *Price Cap Performance Review for Local Exchange Carriers*, 10 FCC Rcd 8961 (Continued...)

Second, the cause of changes in demand is irrelevant to the question of whether costs are properly recovered. As Dr. Gollop has shown, the X-factor already accounts for demand growth.[85] Arbitrarily lowering access charges to favor IXC interests simply skews the balance in their favor, without any improvement in the efficiency of the charge and without any underlying theoretical justification.

Third, it is far too late in the day to be fiddling with the computation of the CCL charge, especially if the FCC adopts the CALLS proposal. The CCL charge is already rapidly being phased out in favor of flat-rated recovery elements. The CALLS proposal further ensures that the CCL charge will be phased out rapidly.[86] The FCC should therefore waste no further time on modifying the price cap common line formula.

## VI. CONCLUSION

For the foregoing reasons, and for those presented in its opening comments, GTE respectfully urges the Commission to grant ILECs immediate flexibility to

---

(...Continued)

(First Report and Order) (1995).

[85] *See* Gollop Reply. As Bell Atlantic stated in its comments, if anything, the g factor should be eliminated altogether. Bell Atlantic at 15-17. Although GTE agrees with Bell Atlantic on this point, it disagrees that the change, if adopted, should be applied retroactively. Retroactive changes to the price cap formula harmfully undermines the incentive structure of price caps and legitimate business expectations.

[86] *Ex Parte* Letter from John Nakahata to Magalie Roman Salas (FCC, Secretary) on August 20, 1999 (attachment, Memorandum in Support of the Coalition for Affordable Local And Long Distance Service Plan ("CALLS Proposal") at Section 2.1.5.6.1.

deaverage access prices, to set reasonable and fixed standards for further deregulation, and to reject unnecessary and inappropriate changes to Part 69 rate structure rules and the price cap system.

Respectfully submitted,

GTE SERVICE CORPORATION and its above-listed affiliates

By: William B. Baker

Gregory J. Vogt
William B. Baker
WILEY, REIN & FIELDING
1776 K Street, N.W.
Washington, D.C. 20006
(202) 719-7000

Gail L. Polivy
GTE Service Corporation
1850 M Street, N.W.
Suite 1200
Washington, D.C. 20036
(202) 463-5214

Thomas R. Parker
GTE Service Corporation
600 Hidden Ridge, MS HQ-E03J43
P.O. Box 152092
Irving, Texas 75015-2092
(972) 718-6361

Its Attorneys

November 29, 1999