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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

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FEDERAL COMMUNICATIONS COMMISSION
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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

REPLY COMMENTS OF U S WEST, INC.

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SUMMARY

Contrary to the suggestion of some commenters, the Commission should continue to emphasize deregulatory, market-based approaches to resolving the issues in this proceeding.

First, the Commission should give LECs the flexibility to respond to market forces by permitting them to deaverage rates in the common line and traffic-sensitive baskets. The Commission should not hamper such deaveraging with unnecessarily burdensome regulatory preconditions, as some commenters propose. These commenters purport to be worried about cross-subsidization. However, the point of deaveraging is to *reduce* the cross-subsidies inherent in averaged rates, and any risk of new cross-subsidies in the reverse direction can easily be prevented by the same types of safeguards that the Commission has adopted for the trunking basket.

The real goal of the opponents of deaveraging is to *preserve* existing cross-subsidies, because those cross-subsidies artificially enhance the opponents' ability to win the business of lucrative urban business customers. The Commission should not participate in this effort to forestall deaveraging and its procompetitive benefits. But if the Commission nonetheless imposes conditions or otherwise restricts deaveraging, it should provide at the very least that the adoption of deaveraged UNE rates in a study area will immediately trigger a LEC's right to deaverage there.

Second, the Commission should not manipulate the price cap system as a prescriptive means of reducing access charges. In particular, there is no economic justification for adopting a q factor. Commenters supporting the adoption of a q factor rely on the demonstrably false premise that switching costs are non-traffic sensitive. In fact, unlike the common line costs addressed by the g factor, switching costs are incurred in a traffic sensitive

manner. Therefore, the rationale for adopting a g factor, whatever its validity, simply does not apply to q. And it is irrelevant whether LECs' rates-of-return in the switching basket appear to be relatively high: The rate-of-return in an individual basket is largely an artifact of regulatory decisions concerning cost allocation, separations, and the application of the X-Factor, and therefore provides no useful information about how well the price cap system is functioning or whether rate formulas need to be adjusted.

There likewise is no sound rationale for mandating yet another "one time" reinitialization of LEC access rates. To the contrary, continually reinitializing rates all the way back to 1991 eviscerates the predictability of the price cap system and severely undermines the incentives that the system was intended to promote.

Finally, consistent with its stated intention to favor a "marketplace solution," the Commission should address any problem with CLEC access charges not through new rate regulation, as many commenters propose, but rather through an expedited complaint process.

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REPLY COMMENTS OF U S WEST, INC.

U S WEST, Inc. ("U S WEST") submits these reply comments in response to the Commission's Further Notice of Proposed Rulemaking ("FNPRM") in the above captioned proceedings.[1] Contrary to the suggestion of some commenters, the Commission should use this proceeding to reaffirm its deregulatory, market-based approach to access reform, not to abandon or undercut that approach by needlessly limiting LECs' ability to respond to market forces or by ordering arbitrary rate cuts. Specifically, the Commission should not hamper permissive rate deaveraging, an important procompetitive reform, with burdensome regulatory preconditions that would effectively prevent LECs from engaging in rate deaveraging for the indefinite future. Nor should the Commission manipulate price cap formulas to prescribe dramatic, regulatory-driven reductions in access charges — particularly since the specific manipulations proposed lack any

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1/ *Access Charge Reform*, Fifth Report and Order and Further Notice of Proposed Rulemaking, FCC 99-206 (rel. Aug. 27, 1999) ("Order" or "FNPRM") ¶¶ 190-257.

sound economic justification and would undermine the efficient incentives that the price cap regime is intended to foster.

I. THE COMMISSION SHOULD NOT IMPOSE BURDENSOME REGULATORY CONDITIONS ON THE AVAILABILITY OF DEAVERAGING IN THE COMMON LINE AND TRAFFIC-SENSITIVE BASKETS.

AT&T and other commenters ask the Commission to hamper deaveraging in the common line and traffic-sensitive baskets with burdensome and unnecessary conditions, purportedly to avert a risk of cross-subsidization. What these commenters really want to do is *preserve* the existing cross-subsidization inherent in geographic averaging, because it artificially enhances their ability to target highly profitable urban business customers. Moreover, the conditions they suggest would be counterproductive and unnecessary.[2/]

The Commission should reject the proposals to make deaveraging dependent on such burdensome regulations. Instead, the Commission should permit deaveraging in the common line and traffic-sensitive baskets subject to the same sensible and straightforward safeguards that the Commission has adopted for deaveraging in the trunking basket.

[2/] Indeed, AT&T and MCI WorldCom appear determined to resist any and all deaveraging of access charges: Both carriers have filed petitions for review of the pricing flexibility rules that the Commission adopted in the Order accompanying the FNPRM, including the decision to permit deaveraging in the trunking basket. *AT&T Corp. v. FCC,* Case No. 99-1404 (D.C. Cir.) (filed Oct. 4, 1999); *MCI WorldCom v. FCC,* Case No. 99-1395 (D.C. Cir.) (filed Sept. 23, 1999).

A. Geographic Deaveraging in the Common Line and Traffic-Sensitive Baskets Would *Reduce* Existing Cross-Subsidies, and Any Risk of New Cross-Subsidies in the Reverse Direction Can Be Controlled with Conditions of the Type That Apply to Deaveraging in the Trunking Basket.

A number of commenters suggest that permitting deaveraging in the common line and traffic-sensitive baskets without requiring a detailed competitive showing would enable incumbent LECs to engage in competitively harmful cross-subsidization.[3] This argument gets the likely effect of geographic deaveraging exactly backwards. Today, rates in low-cost areas (such as high-density urban areas) are inflated to subsidize rates in high-cost areas (such as low-density rural areas). The purpose of deaveraging is to *reduce* the level of existing cross-subsidization and the economic distortions that result. As the Commission observed in permitting deaveraging in the trunking basket, "[g]ranting incumbent LECs more flexibility to deaverage . . . rates enhances the efficiency of the market . . . by allowing prices to be tailored more easily and accurately to reflect costs."[4] The result is a "decrease [in] the likelihood of cross-subsidization."[5]

Despite the general economic case for deaveraging, current and potential CLECs have a vested interest in maintaining the current cross-subsidy structure, because it gives them an artificial advantage vis-a-vis the incumbent LEC in competing for urban business customers, the most lucrative segment of the communications market. So long as the incumbent's rates in low-

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[3] *See* Comments of AT&T at 3; Comments of MCI WorldCom Comments at 2-3; Comments of Time Warner Telecom at 28-29.

[4] Order ¶ 59.

[5] Order ¶ 64.

cost urban areas are inflated due to geographic averaging, CLECs that focus on serving such areas can undercut the incumbent and still earn artificially large profits. Not surprisingly, therefore, the commenters opposing deaveraging are actual or potential CLECs. Also not surprisingly, these commenters fail to mention, much less discuss, the important role of deaveraging in reducing cross-subsidization and promoting competition.

Instead, the opponents of deaveraging fabricate concern about the possibility of cross-subsidization in the opposite direction — that is, the supposed risk that price cap LECs could inflate rates in less competitive rural markets in order to support artificially low rates in highly competitive urban markets. In other words, they envision that the pendulum would swing from its current position (significantly inflated urban rates and subsidized rural rates), past the position of economically rational pricing, to the other extreme (significantly subsidized urban rates and inflated rural rates).

Because this scenario would represent such a radical reversal of the current situation, it would be relatively easy to guard against with simple, easy-to-administer conditions — the same type of conditions that the Commission prescribed with respect to deaveraging in the trunking basket. Specifically, establishing a limit on permitted annual price increases within each zone would prevent any sharp swing in prices. Minimum revenue levels for each zone would be an additional useful safeguard. As in the case of the trunking basket, these safeguards would as a practical matter provide ample protection against any risk of anticompetitive effects.[6/] No competitive showing is necessary.

B. The Preconditions to Deaveraging Suggested by AT&T and MCI WorldCom Would Be Counterproductive and Unnecessary.

As U S WEST discussed in its opening comments in this proceeding, the experience with density zone pricing demonstrates that carriers will not take full advantage of deaveraging if doing so requires them to make a burdensome regulatory showing.[7/] Thus, as a general matter, requiring a detailed competitive showing would thwart the economic benefits of deaveraging. Moreover, requiring a competitive showing *before* deaveraging is permitted ignores the substantial role that deaveraging plays in creating appropriate economic signals that enable widespread competition to develop in the first place.[8/]

The specific preconditions proposed by AT&T and MCI WorldCom are particularly unwarranted and are intended primarily to serve their interests in entirely forestalling deaveraging. AT&T suggests that, as a precondition to deaveraging in the common line basket, all access rates should be set at forward-looking costs.[9/] It is ironic that AT&T would make deaveraging — an essential step towards creating a pricing regime in which rates will accurately

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6/ *See* Order ¶ 63 (in light of limit on price increases and minimum per-zone revenue requirement, Commission "not persuaded by AT&T's claims that greater geographic deaveraging flexibility will lead to predatory pricing by incumbent LECs" for trunking basket elements).

7/ Comments of U S WEST at 4.

8/ *See* Order ¶ 61 (averaging "reduce[s] the incentives for entry" in high-cost areas); *id.* ¶ 59 (deaveraging "promotes competition in both urban and rural areas").

9/ Comments of AT&T at 4-5.

reflect costs — contingent upon the *prior* adopting of fully cost-based rates. In effect, AT&T purports to support the goal of cost-based pricing while opposing one of the key reforms necessary to achieve it.

AT&T and MCI WorldCom likewise argue that the CCL and PICC must be reduced to zero before a LEC should be permitted to deaverage its common line rates, apparently on the ground that these charges are or contain subsidy elements.[10/] In effect, AT&T and MCI WorldCom want to put off deaveraging until all other common line access charge reforms have been completed. The Commission should reject this suggestion; deaveraging has sound economic justifications and should not be held hostage to longer term projects such as the shifting of access service cost recovery from IXCs to end users.

MCI WorldCom also seeks to use deaveraging as an excuse to impose new, unrelated regulatory mandates. Specifically, MCI suggests that an incumbent LEC should be required to provide the "UNE platform" throughout a service area before being permitted to deaverage common line rates there.[11/] This proposed requirement would trump the Commission's newly adopted unbundling rule under which, subject to certain conditions, LECs need not provide unbundled access to switching in certain urban areas.[12/] This rule reflects a finding that, in such urban areas, lack of access to an incumbent LEC's switching would not

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10/ Comments of AT&T at 4-5; Comments of MCI WorldCom at 4.

11/ Comments of MCI WorldCom at 4.

12/ *See Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, Third Report and Order, CC Docket No. 96-98, FCC 99-238 (rel. Nov. 5, 1999) ¶¶ 276-299.

impair a new entrant's ability to provide service. MCI WorldCom does not and cannot explain why an incumbent LEC should be required to provide access to *all* unbundled elements, even those that the Commission has found that competitors do not necessarily need, in order to be permitted to deaverage common line rates. In short, incumbent LECs naturally will be required to comply with all applicable unbundling rules, but there is no basis for imposing further regulatory requirements as preconditions to deaveraging.

AT&T also argues that, before permitting deaveraging of common line rates, the Commission should forbear from enforcing section 254(g), which requires geographic averaging of long distance rates.[13] There is no basis for linking the two issues in this fashion. Contrary to AT&T's apparent assumption, it is perfectly possible to have a regulatory regime in which deaveraged access rates coexist with averaged long distance rates. Indeed, Congress apparently intended just such a result: Congress undoubtedly was aware at the time it passed the Telecommunications Act of 1996 that access rates differed from state to state and even from ILEC to ILEC within a state, yet it required in section 254(g) that each IXC charge the same long distance rates in all states.[14] The Commission has previously rejected IXC requests for forbearance from section 254(g) on precisely this ground.[15]

Finally, AT&T and MCI propose a variety of regulatory measures designed to

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13/ Comments of AT&T at 3.

14/ *See* 47 U.S.C. § 254(g).

15/ *Access Charge Reform*, First Report and Order, 12 FCC Rcd. 15982, 16022 ¶ 97 (1997) ("IXCs now pay access charges that often vary from location to location and from incumbent LEC to incumbent LEC, and still maintain geographically averaged rates. We therefore conclude that . . . forbearance of section 254(g) is not warranted.").

constrain a LEC's flexibility once it has obtained authority to deaverage its common line rates.[16] Once again, the Commission should reject the invitation to take an unnecessarily regulatory approach to deaveraging. As the Commission found in the case of the trunking basket, deaveraging is most likely to yield beneficial economic results if price cap LECs are allowed flexibility to respond to market forces: "[I]f we grant incumbent LECs practical flexibility to choose the number of zones and the criteria for establishing zone boundaries, they are more likely to establish reasonable and efficient pricing zones than if their flexibility is more constrained."[17]

C. Contrary to Opponents' Contentions, the Sound Policy Rationale for Permissive Deaveraging Applies in the Case of the Traffic-Sensitive Basket.

AT&T contends that, even if the Commission permits deaveraging of common line rates, it should not permit deaveraging of traffic-sensitive access elements.[18] The premise of this argument is that "[t]here is no evidence to suggest that the costs of these elements vary geographically within a study area."[19] But while the cost of traffic-sensitive elements may exhibit less geographic variation than elements in other baskets, it simply is not true that traffic-sensitive elements do not vary geographically at all. For example, as Sprint indicated in its

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16/ *See* Comments of AT&T at 6-7; Comments of MCI WorldCom at 4-7.

17/ Order ¶ 62.

18/ Comments of AT&T at 7-8.

19/ *Id.* at 7.

opening comments, switching costs tend to vary with density.[20]

Because there always will be at least some variation in costs, sound economic principles support giving carriers the flexibility to allow prices to vary between regions, however large or small the cost difference between the regions may be. At most, relatively small price differences reduce the *urgency* of the need for deaveraging, but they do not suggest that the general rationale for deaveraging does not apply.

D. At a Minimum, Price Cap LECs Should Be Permitted To Deaverage Access Rates in a Study Area Immediately upon the Deaveraging of UNE Rates in That Study Area.

Whether or not the Commission decides to impose conditions or otherwise restrict deaveraging in the common line and traffic-sensitive baskets — and it should not — the Commission should at least provide that, regardless of those conditions or restrictions, the deaveraging of UNE rates in a study area will immediately trigger the LEC's right to deaverage access rates there.[21] As discussed in U S WEST's opening comments, failing to permit deaveraging under such circumstances would lead to arbitrage, underrecovery by price cap LECs, and uneconomic distortions to competition.[22] Significantly, the potential for arbitrage is acknowledged even by some commenters that are otherwise opposed to deaveraging.[23]

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[20] Comments of Sprint at 7.

[21] As explained in U S WEST's opening comments, it is important that any rule allowing such deaveraging should be permissive rather than mandatory. *See* Comments of U S WEST at 7.

[22] Comments of U S WEST at 6.

[23] *See* Comments of Time Warner Telecom at 30 ("It is true that forcing ILECs to retain geographically averaged loop prices in its [sic] Part 69 rates at the same time as unbundled (continued...)

II. THE COMMISSION SHOULD NOT MANDATE A CAPACITY-BASED RATE STRUCTURE FOR SWITCHING.

U S WEST agrees with the many commenters that expressed opposition to the Commission's proposal to require a capacity-based rate structure for switching. Many of these commenters echoed U S WEST's concerns that such a rate structure would cause carriers to incur additional implementation costs,[24/] cause significant practical difficulties,[25/] and in the end not necessarily improve the economic performance of the rate system.[26/] In short, there is a general consensus that the costs and disadvantages associated with a capacity-based rate structure outweigh the potential benefits, if any. Accordingly, the Commission should not mandate a capacity-based rate structure for local switching.

III. THE COMMISSION SHOULD NOT MANIPULATE THE PRICE CAP SYSTEM TO FORCE ARBITRARY REDUCTIONS IN ACCESS RATES.

AT&T, MCI WorldCom, and others treat this proceeding as an opportunity to obtain large, prescriptive reductions in access charges, thus circumventing the Commission's

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23/ (...continued)
loops can be purchased on a geographically deaveraged basis could create opportunities for arbitrage.").

24/ *See, e.g.,* Comments of U S WEST at 9-10; Comments of MCI WorldCom at 11; Comments of Time Warner Telecom at 34; Comments of CompTel at 6; Comments of Sprint at 12.

25/ *See, e.g.,* Comments of U S WEST at 10-13; Comments of AT&T at 15; Comments of MCI WorldCom at 10; Comments of ALTS at 31; Comments of CompTel at 6-7; Comments of Sprint at 11-12; Comments of USTA at 14-15.

26/ *See, e.g.,* Comments of U S WEST at 14-15; Comments of AT&T at 12-15; Comment of MCI WorldCom at 11-12; Comments of Time Warner Telecom at 33-34; Comments of ALTS at 30-31; Comments of CompTel at 5-6; Comments of Sprint at 12-13; Comments of USTA at 11-15.

market-based approach to access reform. But the specific price cap formula manipulations that they seek are demonstrably contrary to sound economics and policy, and in some cases are not even germane to this proceeding. The Commission should not adopt any of these proposals.

A. Commenters Supporting a "q" Factor Rely on Demonstrably False Premises.

In the FNPRM, the Commission asked whether, if it requires a capacity-based rate structure for switching, it also should adopt a "q" factor similar to the g factor that applies in the common line basket.[27/] While commenters generally oppose the capacity-based rate structure, a few argue that a q factor is warranted even if the current per-minute rate structure is retained.[28/] However, the sound economic arguments against a q factor are just as applicable to a per-minute rate structure as to a capacity-based rate structure. Simply put, there is no economic justification for adopting a q factor.

Commenters supporting the q factor start from the premises that (i) LECs incur switching costs in a manner that is at least partly non-traffic-sensitive, and (ii) the argument for a q factor in the switching basket therefore is essentially identical to the argument for a g factor in the common line basket. Thus, AT&T states that the costs of local switching "tend not to increase with growth in traffic," and that "[t]he *same reasons* for including the g factor in the common line formula also support the adoption of a q factor for the traffic-sensitive basket."[29/]

27/ FNPRM ¶ 218.

28/ Comments of AT&T at 17-19; Comments of Ad Hoc Telecommunications Users Committee at 6-8.

29/ Comments of AT&T at 18, 17 (emphasis added).

Ad Hoc likewise asserts that "local switching costs will not tend to vary directly with the associated per-trunk demand" and that a q factor is justified based on the "same economic trends and factors" that supposedly justify the g factor.[30/]

These premises are demonstrably wrong. As explained in U S WEST's opening comments, the fact that LEC switching costs are incurred in a "lumpy" fashion does not make those costs any less traffic sensitive.[31/] In economic terms, every incremental increase in switching traffic uses up valuable switch capacity and is ultimately responsible for "causing" additional switching investments by the LEC. Thus, there is a real economic cost associated with every unit of increased switching traffic. Switching costs are traffic sensitive.

By contrast, the common line costs addressed by the g factor present an entirely different case. Unlike a switch, a common line is devoted to a single end user. Therefore, there is no risk that traffic will outstrip capacity: A customer (or indeed all customers) could stay on the phone a full 24 hours a day without forcing the LEC to make additional common line investment. In other words, LEC common line investment is triggered not by increases in traffic volumes — as in the case of switching investment — but rather by customer requests to install additional common lines. Thus, an increase in the usage of a common line, unlike an increase in the usage of a switch, does not add to the LEC's real economic costs associated with that element.

It follows that the rational for adopting a g factor — whatever validity it may have

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30/ Comments of Ad Hoc Telecommunications Users Committee at 8, 6.

31/ Comments of U S WEST at 17-19.

— cannot be used to support the adoption of a q factor. Even if the Commission were correct that growth in usage of existing common lines leads to "windfall" revenues absent a g/2 factor, growth in usage of existing switches does not create any such windfall. Rather, growth in switching traffic imposes real economic costs on LECs. As these costs grow, LEC revenues must grow as well. There is no economic basis for imposing a q factor to reduce or eliminate such revenue growth.

The absurdity of treating switching costs as non-traffic sensitive can easily be seen by analyzing the proposal to reinitialize rates as if a q factor had been in place since 1991.[32/] The premise for applying a q factor to all traffic growth over such a multiyear period would have to be that every minute of increased switching traffic during those years resulted in windfall revenues for the LEC — that is, revenues that were not justified by the need for additional cost recovery. In other words, the proposal assumes that the growth in switching from 1991 to the present did not cause LECs to incur increased switching costs. That is assumption is patently unsupportable. LECs invested substantial sums of money in additional switching capacity during the 1990s, and they did so precisely because of growth in traffic volumes. There is no economic basis for reducing LECs' cost recovery simply because each incremental minute of use is not *individually* responsible for an identifiable investment expense.

AT&T attempts to support its premise that switching costs are not traffic sensitive by arguing that "[d]espite substantial growth in local switching minutes over time . . . expenses and investments associated with local switching in ARMIS have declined substantially over

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32/ *See* FNPRM ¶ 222; Comments of AT&T at 19-20.

time."[33] But even if AT&T's data are correct, they suggest only that *unit* costs for switching may be declining. This has nothing to do with whether switching rates are traffic sensitive: Even if the per-minute rate for switching is lower than it was a few years ago, it still is the case that a LEC's *total* switching costs increase as switching volumes rise.[34]

AT&T also seeks to support imposing a q factor by presenting rate-of-return figures purporting to show a high rate-of-return for RBOC local switching.[35] As a preliminary matter, continued scrutiny and regulation based on rates-of-return were precisely what the price cap regime was designed to avoid. But in any event, AT&T's calculations are highly misleading.

It is neither useful nor accurate to consider the rate-of-return of an individual price cap basket. The apparent rate-of-return for any individual basket is largely an artifact of policy-driven regulatory decisions governing the allocation of costs and revenues among baskets. Each time the Commission modifies its price cap rate structure — for example, by shifting specific elements from one basket to another — it affects the rate of return in the various baskets, even if the modification is revenue-neutral for the LEC as a whole. Not surprisingly, the accumulated impact of such decisions can be substantial, causing rates-of-return to appear high in some baskets and low in others. Moreover, the apparent rate-of-return for interstate services generally is a product of the artificial workings of the separations process. In short, a LEC's apparent rate-

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33/ Comments of AT&T at 18.

34/ Moreover, if switching productivity has been growing, that is precisely the type of efficiency gain that the price cap system was designed to promote and that the X-Factor is intended to account for.

35/ Comments of AT&T at 18.

of-return in a particular price cap basket says very little about the LEC's actual performance or profitability.

In the case of the local switching basket, it is not difficult to find reasons why the rate-of-return may appear high when considered in isolation. For example, in 1997, as part of its restructuring of access charges, the Commission required price cap LECs to apply all annual X-Factor rate reductions to the TIC, and to continue to do so until the TIC is eliminated.[36] Therefore, for the last several years, annual rate adjustments that would have decreased LEC switching revenues have been redirected, by order of the Commission, to reduce the TIC instead. It would be patently unfair effectively to penalize price cap LECs for the Commission's policy decision by now forcing cuts in switching rates on top of the annual X-Factor cuts that already have been applied to the TIC.

Furthermore, even in years in which the Commission has applied the X-Factor to the switching basket, it has used a single X-Factor that is intended to reflect a LEC's *overall* productivity gains; the Commission has never attempted to adopt different X-Factors on a basket-by-basket basis. An X-Factor that reflects *overall* productivity gains necessarily will overstate productivity gains in some baskets and understate them in others. Thus, over time, the operation of the X-Factor will cause some baskets (those with relatively low productivity gains) to appear to have low rates-of-return and other baskets (those with relatively high productivity gains) to have high rates-of-return. This effect is an inevitable byproduct of the current price cap system. Accordingly, there is nothing inappropriate or suspicious about a high apparent rate-of-

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[36] *Access Charge Reform*, First Report and Order, 12 FCC Rcd at 16081 ¶¶ 229-30, 16083-84 ¶¶ 234-38.

return in the switching basket — it merely reflects the fact that productivity in the switching basket has been increasing faster than it has in other baskets.

Finally, the treatment of Internet traffic in the separations process skews the apparent rate-of-return in the interstate switching basket. The rise of the Internet has sharply increased usage per line, which, because switching costs are traffic sensitive, increases a LEC's switching costs. Yet while the Commission has recognized Internet calls to be generally interstate, Internet traffic is treated as local for separations purposes. The huge influx of new *intrastate* switching minutes means that an ever-higher proportion of a LEC's switching costs are assigned to the intrastate jurisdiction. Meanwhile, the relationship between the LEC's interstate and intrastate *revenues* remains essentially constant, because Internet traffic is included in flat-rated local service plans and hence does not result in increased revenues for the LEC. The declining share of costs assigned to the interstate switching basket, with no corresponding change in revenues, artificially drives up the apparent rate-of-return for interstate switching and drives down the apparent rate-of-return on the intrastate side.[37]

In sum, a relatively high apparent rate-of-return in an individual basket does not in any way indicate that the price cap system is not working or needs to be adjusted. There is no sound basis for adopting a q factor.

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[37] For a more detailed discussion of this issue, and of other ways in which the separations process drives apparent interstate rates-of-return, see Supplemental Comments and Submissions of U S WEST Communications, Inc., *Access Charge Reform*, CC Docket No. 96-262 (filed Oct. 26, 1998) at 7-9.

B. The Commission Should Reject the Non-Germane Requests of AT&T and MCI WorldCom for Prescriptive Access Charge Reductions That Would Be Inconsistent with the Commission's Market-Based Approach to Access Reform.

AT&T and MCI WorldCom present non-germane arguments that amount to back door attempts to have the Commission abandon its market-based approach to access reform and replace it with a highly regulatory, prescriptive approach. The Commission should ignore these arguments, for the same reasons the Commission has rejected a prescriptive approach in the past.

As noted above, AT&T argues that, as a precondition to deaveraging, "carrier-paid access rate elements must be set at forward-looking economic cost."[38] Clearly, for this to be an enforceable precondition, the Commission would have to prescribe the specific rates that satisfy this standard — a step that would be totally incompatible with the premises and goals of price cap regulation.

AT&T then goes on to discuss the alleged risk of a "cost/price squeeze created by excessive LEC access rates."[39] But the Commission already has found that numerous existing regulatory safeguards, from separation requirements to nondiscrimination provisions to the antitrust laws, nullify any such risk.[40] And more fundamentally, the entire price squeeze issue simply is not pertinent to this proceeding — it is a (failed) argument for a prescriptive reduction

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38/ Comments of AT&T at 5.

39/ *Id.*

40/ *See Access Charge Reform*, First Report and Order, 12 FCC Rcd at 16100-04 ¶¶ 275-82.

in access charges, but has no relation to the issues of geographic deaveraging or rate structure changes.

MCI WorldCom does not even attempt to link its request for a prescriptive rate reduction to any question raised in this proceeding:

> The Commission's first step, before considering any significant rate structure changes, should be to correct for the factors that have caused the price cap LECs' local switching revenue to be inflated. MCI WorldCom has consistently advocated a prescriptive approach that would reduce interstate access charges, including local switching charges, to forward-looking economic cost. The Commission should immediately open a supplementary proceeding to establish forward-looking cost levels for access.[41]

Clearly, this has no bearing on the present proceeding. And in any event, the Commission was right to conclude that a market-based approach to access reform has substantial advantages over a prescriptive one.[42] The Commission should reject the invitation to abandon the market-based approach.

C. The Commission Should Not Adopt AT&T's Suggestion of Imposing a Cap on Revenues Per Line.

The Commission should reject AT&T's argument for a per-line cap on common line revenues.[43] To the extent that differences in growth rates between multiline business lines and residential and single-line business lines result in over collection or under collection of subsidies embedded in multiline business rates, the simplest and most economically sound

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41/ Comments of MCI WorldCom at 13-14.

42/ *See, e.g., Access Charge Reform*, First Report and Order, 12 FCC Rcd at 16094 ¶ 263 (describing advantages of market-based approach).

43/ Comments of AT&T at 20-25.

solution is to cease differentiating rates by class of customers. The result would be a unified rate structure in which each line is treated the same regardless of the identity of the user. Indeed, AT&T acknowledges the viability of such an approach.[44]

D. The Commission Should Not Increase the Fraction g/2 and in Any Event Should Refrain from Implementing Yet Another "One Time" Reinitialization of Rates.

The Commission's proposal to increase the fraction g/2 is premised on the false assumption that IXCs are solely responsible for the growth in interstate line usage and accordingly should receive the entire benefit of such growth. However, as U S WEST explained in its opening comments, U S WEST is partly responsible for the increase in interstate common line usage in its region: It has reduced access charges, conducted advertising and marketing campaigns aimed at increasing telephone use generally, and promoted products that involve the use of interexchange access, such as caller ID, long distance caller alert, voice mail, and three-way calling.[45] Accordingly, it is entirely appropriate that U S WEST should share in the benefits of increased interstate common line usage. In addition, much of the increase in interstate common line usage during the 1990s is undoubtedly due to the prolonged nationwide economic boom. To the extent that this is the case, neither LECs nor IXCs are "responsible" for the increase in usage — rather, that increase is a fortuitous result of factors that neither LECs nor IXCs control. Thus, there would be no basis for allowing IXCs to collect the entire benefit of such usage growth.

44/ *See* Comments of AT&T at 25 n.42.

45/ Comments of U S WEST at 22 & n.39.

Nor should the Commission reinitialize rates as if it had adopted a fraction higher than g/2 in some prior year. First, such a reinitialization would have a highly disruptive impact on the effectiveness of the price cap regulatory regime. In a rate-of-return environment, LEC investment involved limited risks and limited rewards: The regime permitted a LEC to recover the cost of its investment plus a fixed rate of profit. The shift to a price cap regime purposefully increased both the risks and potential rewards, on the assumption that market-based incentives would spur efficiency and lead to better investment decisions. But this incentive structure cannot work if there is a constant threat that the Commission will scrutinize profits and order negative price cap adjustments whenever it considers the profit earned by a LEC to be "excessive." In short, as U S WEST discussed in its opening comments, frequent reinitializations drain the price cap regime of predictability and undermine the effectiveness of the incentive system it is intended to foster.[46/]

Indeed, as time passes, the impact of reinitialization on the predictability of the price cap regime grows more severe. A number of commenters seek reinitialization all the way back to 1991.[47/] Whatever impact such a reinitialization might have had in, say, 1995 (the year the Commission reinitialized to correct for the allegedly erroneous inclusion of a 1984 data point in setting the original X-Factor[48/]), the impact would be many times larger in 2000, with nine

46/ *See* Comments of U S WEST at 20-21.

47/ *See* Comments of AT&T at 26; Comments of MCI WorldCom at 17; Comments of Ad Hoc Telecommunications Users Committee at 8.

48/ *See Price Cap Performance Review for Local Exchange Carriers,* 10 FCC Rcd. 8961 (1995).

years to compound the effects rather than four. Thus, if the Commission were to demonstrate a willingness to continue to reinitialize rates all the way back to the beginning of the price cap regime, LECs would be forced to contend with tremendous uncertainty in revenue levels, and LEC investment — which depends heavily on projected revenues — would suffer accordingly.

In addition, while the Commission has in the past reinitialized rates to correct an alleged *error* in prior estimates, there is nothing "erroneous" or "inaccurate" about g/2. The fraction g/2 was essentially just a policy choice: The Commission believed that common line growth led to a revenue windfall, and it elected to divide that windfall between LECs and IXCs.[49/] Furthermore, common line rates are not now and have not previously been particularly high relative to costs.[50/] Therefore, even if the Commission modifies its earlier policy choice by adopting a different g factor on a prospective basis, there is no reason to apply that choice retroactively through reinitialization.

Ad Hoc nonetheless argues for a reinitialization to "correct on a going-forward basis for the observed imbalances resulting from the recovery of essentially flat costs through

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49/ *See Access Charge Reform,* First Report and Order, 12 FCC Rcd at 16027 ¶ 109 (making policy to decision not to modify the fraction g/2).

50/ As discussed above, U S WEST maintains that it is inappropriate to analyze rates-of-return on an individual, basket-by-basket basis. However, if the Commission gives any weight in the q factor context to AT&T's allegation of high rates-of-return for local switching, then consistency would require it to consider rates-of-return in the common line basket before deciding to reinitialize based on an increased fraction of g. U S WEST's calculates that its rate-of-return in the common line basket has been and continues to be substantially lower than the returns that were permitted under the old rate-of-return regime. If the Commission were to reinitialize common line rates as if full g had been in place since 1991, that already low rate-of-return would be slashed dramatically.

traffic-sensitive rates."[51] But reinitializing based on a different g fraction does not achieve such a correction. The problem with recovering flat costs through traffic-sensitive rates is that it skews incentives, resulting in underutilization of the network.[52] The incentives that parties faced in prior years, however skewed they may have been, cannot now be corrected through a reinitialization or any other means; all the Commission can do is ensure that the rate system creates proper incentives on a forward-looking basis, by ensuring that there is no continuing mismatch between the way costs are incurred and the way rates are set. That does not require a reinitialization.

IV. The Commission Should Expedite Complaints Concerning Excessive CLEC Access Charges, But Should Not Adopt "Benchmarks" or Other CLEC Rate Regulation.

U S WEST supports the Commission's stated intention to favor a "marketplace solution" and to "seek the least intrusive means possible to correct any market failures" with regard to excessive access charges imposed by CLECs.[53] Accordingly, U S WEST suggested in its opening comments that, rather than regulate CLEC access charges, the Commission should address problematic CLEC access charges through its complaint procedure on an expedited basis.[54] If the Commission makes clear that it will deal swiftly with complaints about unreasonable CLEC access charges, most CLECs will not impose excessive access charges, and

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51/ Comments of Ad Hoc Telecommunications Users Committee at 8.

52/ *See Access Charge Reform,* First Report and Order, 12 FCC Rcd at 15995-96 ¶ 30, 16008 ¶ 69.

53/ FNPRM ¶¶ 247, 256.

54/ Comments of U S WEST at 26.

any holdouts can be dealt with in a few quick complaint proceedings.

However, many commenters support imposing some form of rate regulation on CLEC access charges. In particular, several commenters support the adoption of some type of "benchmark" by which to judge CLEC access charges.[55] No benchmark or other rate regulation is necessary to correct any problem of excessive CLEC access charges. First, imposing new rate regulations on a class of services that has not yet been regulated would be inconsistent with the Commission's overall effort to move in the direction of deregulation. Second, as some commenters note, whether a particular CLEC's access charges are "just and reasonable" could vary from CLEC to CLEC, depending on such factors as whether the CLEC serves sparsely or densely populated areas and whether the CLEC serves mainly residential or business customers.[56] Given these differing circumstances, judging whether CLEC access charges are reasonable is a case-by-case undertaking — a situation that calls for individual complaint proceedings rather than industry-wide rulemakings. Third, using incumbent LEC rates as benchmarks would have the undesirable effect of preserving the ability of competitive providers to engage in so-called "umbrella" pricing (in which competitive providers base their rates on the incumbent's tariffed rates) rather than engaging in a more open type of competition. In sum, rate

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55/ *See, e.g.*, Comments of Sprint at 21-23; Comments of CompTel at 3; Comments of the Minnesota CLEC Consortium at 14.

56/ *See, e.g.*, Comments of Cox Communications at 4-5.

regulation for CLEC access charges is unnecessary and therefore is not the "least intrusive means" of addressing the perceived problem.[57]

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November 29, 1999

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[57] *See* FNPRM ¶ 256.

CERTIFICATE OF SERVICE

I DO HEREBY CERTIFY that on this 29th day of November, 1999, I caused true and correct copies of the foregoing Reply Comments of U S WEST Communications, Inc. to be served either by hand* or by first-class mail, postage prepaid, upon the following parties:

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