pricing flexibility. For many years, the incumbent LECs and other communications carriers had been subject to rate of return regulation. In October 1990, the Commission replaced this type of regulation for the largest LECs -- including the Bell Operating Companies -- with an incentive-based system employing price ceilings or "caps" on the aggregate prices the carriers charge for their interstate offerings. *Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, 5 FCC Rcd 6786 (1990) (*Price Cap Order*), *modified on recon.*, 6 FCC Rcd 2637, *further recon. dismissed*, 6 FCC Rcd 7482 (1991), *aff'd*, *National Rural Telecom Ass'n v. FCC*, 988 F.2d 174 (D.C. Cir. 1993). The price cap system, codified in Part 61 of the Commission's rules, is designed to replicate some of the efficiency incentives present in fully competitive markets and to act as a transitional regulatory mechanism on the way to full competition. *Order* ¶ 11 (JA 238).

The LECs have greater pricing flexibility under price caps than under rate of return regulation. Under price caps, the LECs do not have to base their rates strictly upon the accounting costs of providing each service. Rather, interstate rates that fall at or below a price cap for a group of services known as a "basket"[3] and within the specified pricing parameters for service categories within the basket are presumed lawful and are given "streamlined" review. *Price Cap Order*, 5 FCC Rcd at 6788 (¶¶ 11-12). *See Bell Atlantic Telephone Companies v. FCC*, 70 F.3d 1195, 1198 (D.C. Cir. 1996). Rates that fall outside these price constraints face more exacting regulatory scrutiny. *Id.*

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[3] At the time the Commission adopted the *Order*, there were four baskets in the price cap rules: common-line, traffic-sensitive, trunking and interexchange. Each basket is subject to a price cap index ("PCI"), which caps the total charges a price cap LEC may establish for the interstate access services in that basket. 47 C.F.R. § 61.42(d). Since that time, the Commission has removed special access from the trunking basket and created a separate special access basket. *See* MCI Br. at 7 n.3.

(2) Pricing Flexibility

The Commission periodically has fined-tuned its price cap policies in an effort both to give the incumbent LECs greater flexibility to compete effectively and to prevent them from exercising their market power to stifle competitive entry and charge unreasonable rates for less competitive services. *Order* ¶ 67 (JA 267-68). The Commission has long believed that retaining regulations longer than necessary contravenes the public interest. *See, e.g., Order* ¶ 144 (*citing Policy and Rules Concerning Rates for Competitive Carrier Services*, First Report and Order, 85 FCC 2d 1, 3 (1980) (*Competitive Carrier First Report*); *Policy and Rules Concerning the Interstate, Interexchange Marketplace*, Second Report and Order, 11 FCC Rcd 20730, 20762-63 (1996).

Since it adopted the *Price Cap Order*, the Commission several times has increased the LECs' pricing flexibility and their ability to respond to emerging competition, without significantly increasing the risk of predatory pricing and cross-subsidization. For example, when the Commission originally adopted price caps, it required price cap LECs to offer all interstate special and switched access services at uniform, geographically averaged rates within their study areas as a safeguard against unreasonable rates and predatory conduct.[4] In 1994, in response to the increased competitive opportunities resulting from its expanded interconnection decisions, the Commission permitted price cap LECs to geographically deaverage their rates for special access and switched transport services if the LECs met certain interconnection requirements. *Order* ¶ 58 (JA 262-63). *See* 47 C.F.R. § 69.123; *Special Access Expanded Interconnection Order*, 7 FCC Rcd at 7454-56.

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[4] A study area is a geographical segment of a carrier's telephone operations. Generally a study area encompasses a carrier's entire service area within a state. *Order* n.152 (JA 262). *Special Access Expanded Interconnection Order*, 7 FCC Rcd at 7369, 7452 n.403.

The Commission also gradually expanded the price cap LECs' freedom to modify rates within a pricing basket, first by increasing the allowable rate revisions for lower pricing band indices and then by eliminating the lower pricing indices altogether. *Order* ¶¶ 13, 15 (JA 239-40, 241). *See Price Cap Performance Review for Local Exchange Carriers*, First Report and Order, 10 FCC Rcd 8961, 9139-41 (1995), *aff'd. Bell Atlantic Tel. Cos. v. FCC*, 79 F.3d 1195 (D.C. Cir. 1996) ; *Access Charge Reform*, Notice of Proposed Rulemaking, Third Report and Order and Notice of Inquiry, 11 FCC Rcd 21354, 21487 (1996) (*Access Charge Reform*).

In addition, the Commission permitted price cap LECs to offer volume and term discounts for special access and switched transport services subject to certain conditions. *Order* ¶ 123 (JA 298-99). *See Special Access Expanded Interconnection Order*, 7 FCC Rcd at 7463; *Expanded Interconnection With Local Telephone Company Facilities*, 8 FCC Rcd 7374, 7433-35 (1993) (*Virtual Collocation Order*). And it relaxed the procedures for introducing new switched access services by permitting incumbent LECs to file petitions based upon a public interest standard (instead of the more stringent general waiver standard), thereby eliminating costly and time-consuming burdens on the incumbent LECs. *Order* ¶ 34 (JA 17-18). *See* 47 C.F.R. § 69.4(g); *Access Charge Reform*, 11 FCC Rcd at 21490 (¶ 309).

(3) Dominant/Non-Dominant Classification

Consistent with the policy determination that it should eliminate unnecessary regulations, the Commission has distinguished between "dominant" and "non-dominant" firms and has afforded them different regulatory treatment. Under current rules, non-dominant LECs and CAPs – unlike dominant carriers – do not have their rates subject to review prior to taking effect and are not required to file tariffs. *See Hyperion Telecommunications, Inc.*, 12 FCC Rcd 8596, 8611-12 (1997). The Commission has determined that carriers are non-dominant if they are "subject to sufficient competitive pressure so that their performance is, and can be presumed to be, in the public interest without detailed government oversight and intervention." *Competitive Carrier First Report*, 85 FCC 2d at 20 (¶ 55). Non-dominant carriers are those that lack market power to sustain prices either unreasonably above or below costs. *See MCI Telecommunications Corp. v. FCC*, 765 F.2d 1186 (D.C. Cir. 1985).

C. The Telecommunications Act of 1996

The 1996 Act "seeks to open for all carriers the local and long distance telecommunications markets to competition...." *Access Charge Reform*, 11 FCC Rcd at 21373 (¶32). The 1996 Act imposes obligations on ILECs to give their competitors access to the ILECs' local networks. 47 U.S.C. §§ 251-252. Section 251(c) envisions three methods of entry into the local exchange markets: competitors may obtain, at wholesale rates, the ILEC's retail services and resell those services; competitors may lease portions of the incumbent's network through the use of "unbundled network elements"; competitors may build their own facilities and interconnect those facilities with the ILEC's network. 47 U.S.C. §§ 251(c)(2)-(4). In addition, the 1996 Act requires ILECs to permit competitors to collocate their facilities on the ILEC's premises. 47 U.S.C. § 251(c)(6).

Congress anticipated in adopting the 1996 Act that increased competition would go hand in hand with reduced regulation. *See* Joint Managers' Statement, S. Conf. Rep. No. 104-230, 104th Cong., 2d Sess. 113 (1996) at 1 (the Act establishes a "pro-competitive, deregulatory national policy framework"); 110 Stat. at 56 (Introductory Statement) (1996 Act is intended "to promote competition and reduce regulation"). The Act directs the Commission to eliminate, or forbear from applying, regulations under certain conditions. For example, the Commission is required to conduct a biennial review of its rules that apply to the operations or activities of telecommunications service providers and to "repeal or modify any regulation it determines [pursuant to that review] to be no longer in the public interest." 47 U.S.C. § 161. *See also* 47 U.S.C. § 160 (Commission must forbear from applying any of its regulations to telecommunications carriers if it finds that enforcement of the regulations is not necessary to achieve statutory ends and that forbearance is consistent with the public interest).

In a notice proposing to review its regulation of access charges in the light of the 1996 Act, the Commission asserted that its Part 69 access charge rules were "fundamentally inconsistent with the competitive market conditions that the 1996 Act attempts to create." *Access Charge Reform*, 11 FCC Rcd at 21360 (¶ 6). In anticipation of the development of local competition, and in recognition of the deregulatory goals of the 1996 Act, the Commission proposed to eliminate, "either now or as soon as changes in the marketplace permit, any unnecessary regulatory requirements on incumbent LEC exchange access services." *Access Charge Reform*, 11 FCC Rcd at 21359 (¶ 5).[5] The proceeding before the Court commenced with that notice.

II. The Order Under Review

In 1999, the Commission granted limited additional pricing flexibility to ILECs with respect to their interstate access charges. This decision was the logical next step in the Commission's ongoing effort to coordinate reduced regulation with competitive developments. The regulatory relief the Commission granted was incremental: the services are still subject to tariff filing requirements, and most of the services for which the Commission granted flexibility

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[5] The Commission approved some additional pricing flexibility at that time, and noted that "further modifications to the Part 69 rate structure could increase consumer choice, streamline regulation, and increase consumer welfare by increasing incentives for innovation." *Access Charge Reform*, 11 FCC Rcd at 21440-41 (¶18).

remain subject to price cap regulation.[6] The Commission granted some regulatory relief immediately; and it adopted substantive and procedural standards for obtaining additional relief in the future, on proof of specific competitive developments.[7]

A. Immediate Pricing Flexibility

The Commission immediately authorized the LECs to offer substantially deaveraged rates for services in the trunking basket.[8] Previously, price cap LECs could deaverage these rates, but they had to satisfy a rigorous standard in order to establish more than three pricing zones. *Special Access Expanded Interconnection Order*, 7 FCC Rcd at 7454 n. 413. The Commission now allows price cap LECs to define the scope and number of zones within a study area, provided (1) that each zone, except the highest-cost zone, accounts for at least 15 percent of the price cap LEC's trunking basket revenues in the study area, and (2) that annual price increases within a zone do not exceed 15 percent. *Order* ¶ 21 (JA 244). The Commission concluded that these modest limitations would protect against rate shock and prevent LECs from defining narrow zones that are targeted to specific customers. *Order* ¶¶ 62-63 (JA 264-66). The Commission determined that granting additional flexibility to deaverage rates "enhances the efficiency of the market for those services by allowing prices to be tailored more easily and accurately to reflect costs and, therefore, promotes competition in both urban and rural areas." *Order* ¶ 59 (JA 263).

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[6] In some instances, the Commission reduced the length of time that the tariff had to be on file before it could go into effect. For example, carriers that obtain Phase I or Phase II pricing flexibility are permitted to file tariffs on one day's notice. *Order* ¶¶ 122, 153 (JA 298, 310-11), and price cap LECs may file tariffs on one day's notice for new services. *Order* ¶ 40 (JA 252).

[7] No one has yet petitioned for this additional "Phase I" or "Phase II" relief.

[8] These include the special access services that are now in their own separate special access basket.

The Commission also authorized price cap LECs immediately to introduce new services on a streamlined basis without requiring prior approval or the public interest showing that it had required previously. *Order* ¶ 22 (JA 244). In addition, except as to loop-based services, the Commission eliminated the new services test previously required under section 61.49(f) and (g) of its rules. *Id.* The Commission permitted price cap LECs to begin to offer new services on a streamlined basis, but it required that these services eventually be incorporated into the price cap rate structure. *Order* ¶ 43 (JA 253). The Commission noted that, with the growth of competition, the pre-existing new services requirements could place price cap LECs at a competitive disadvantage, because their competitors are not subject to such restrictions and because they have advance notice of the new services that price cap LECs seek to offer. *Order* ¶ 38 (JA 251). The Commission observed that the pre-existing rules reduce the price cap LECs' incentives to develop and offer new services. *Id.*

The Commission immediately permitted price cap LECs to remove their interstate intraLATA services and certain interstate interLATA services (called "corridor services") from price cap regulations, provided that the price cap LEC had implemented dialing parity for inter- and intraLATA toll services. *Order* ¶ 23 (JA 244-45).[9] Once toll dialing parity was implemented, these services would face sufficient competition to "preclude price cap LECs from exploiting over a sustained period any individual market power they may have with respect to these services." *Order* ¶ 45 (JA 254).[10]

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[9] Dialing parity exists when a customer of a competitive carrier can make a call by dialing the same number of digits that a customer of the LEC would dial to make the same call. *See* 47 U.S.C. § 153(15).

[10] MCI does not raise any objection to this part of the Commission's order.

B. Future Opportunities For Increased Pricing Flexibility

The Commission adopted a framework offering progressively greater pricing flexibility as competition develops further. In general the framework provides for rate relief in two phases and on a Metropolitan Statistical Area (MSA) basis.[11] To obtain pricing flexibility under Phase I or Phase II, the price cap LEC must file a petition demonstrating that certain competitive "triggers" have been met within the MSA. The triggers vary depending on the degree of relief requested (*i.e.*, Phase I or Phase II) and on the services for which pricing flexibility is sought.

(1) Phase I Relief

Phase I relief is potentially available, pursuant to varying triggers, for (1) dedicated transport (*i.e.*, entrance facilities, direct-trunked transport, and the dedicated component of tandem-switched transport service) and special access services other than channel terminations;[12] (2) channel terminations;[13] and (3) common line and traffic-sensitive services and the traffic-

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[11] Each area within the United States is classified as either an MSA or an RSA (Rural Service Area). There are 306 MSAs and 428 RSAs. 47 C.F.R. § 22.909. For the Court's convenience, a map designating MSAs and RSAs is attached as Appendix 1.

[12] Specifically, for these services, the trigger requires the ILEC to show that competitors have collocated facilities (a) in at least 15 percent of the wire centers within the MSA for which the ILEC is seeking pricing flexibility, or (b) in wire centers accounting for at least 30 percent of the revenues for the services for which the ILEC is seeking pricing flexibility. In addition, in each of the wire centers relied on by the ILEC in its pricing flexibility petition, at least one competitor must rely on transport facilities provided by an entity other than the ILEC. 47 C.F.R. § 69.709(b).

[13] To obtain pricing flexibility for channel terminations to the end user, the ILEC must show that competitors have collocated facilities (a) in at least 50 percent of the wire centers within the MSA for which the ILEC is seeking pricing flexibility, or (b) in wire centers accounting for at least 65 percent of the revenues for the services for which the ILEC is seeking pricing flexibility. In addition, in each of the wire centers relied on by the ILEC in its pricing flexibility petition, at least one competitor must rely on transport facilities provided by an entity other than the ILEC. 47 C.F.R. § 69.711(b).

sensitive component of tandem-switched transport service.[14] *Order* ¶ 70 (JA 268-69). Phase I relief authorizes price cap LECs to offer volume and term discounts for these services and to offer these services pursuant to contract tariffs. *Order* ¶¶ 24, 122 (JA 245, 298). Price cap carriers that obtain Phase I relief must make contract tariff rates available to all similarly situated customers, and they must make the discounts available to anyone willing to commit to the specified volumes or commit to the specified term. *Order* ¶¶ 124, 130 (JA 299, 302). They also must continue to offer these services pursuant to price caps. *Order* ¶ 24 (JA 245).

(2) Phase II Relief

Phase II relief is potentially available for dedicated transport and special access services. *Order* ¶ 70 (JA 268-69).[15] The *Order* establishes more stringent triggers for Phase I relief than for Phase II relief. As it did with Phase I triggers, the Commission established more stringent triggers associated with pricing flexibility for channel terminations between the end office and the customer premises than it did for other special access and transport services.[16] Phase II relief

[14] To obtain pricing flexibility for this third group of services, a competitor must offer service, using their own transport and switching facilities, to 15 percent of the ILEC's customer locations. 47 C.F.R. § 69.713(b).

[15] The Commission sought comment on appropriate bases for granting Phase II relief for common line and traffic-sensitive services. *Order* ¶ 70 (JA 268-69). It has not yet established triggers for granting such pricing flexibility.

[16] Specifically, with the exception of pricing flexibility for channel terminations to end users, the trigger requires the ILEC to show that competitors have collocated facilities (a) in at least 50 percent of the wire centers within the MSA for which the ILEC is seeking pricing flexibility, or (b) in wire centers accounting for at least 65 percent of the revenues for the services for which the ILEC is seeking pricing flexibility. 47 C.F.R. § 69.709(c). To obtain pricing flexibility for channel terminations to the end user, the ILEC must show that competitors have collocated facilities (a) in at least 65 percent of the wire centers within the MSA for which the ILEC is seeking pricing flexibility, or (b) in wire centers accounting for at least 85 percent of the revenues for the services for which the ILEC is seeking pricing flexibility. 47 C.F.R. § 69.711(c). In addition, in each of the wire centers relied on by the ILEC in its pricing flexibility petition, at least one competitor must rely on transport facilities provided by an entity other than the ILEC. 47 C.F.R. §§ 69.709(c), 69.711(c).

permits LECs to offer these services outside of price cap regulation, but carriers still must file generally available tariffs. *Order* ¶ 151 (JA 310).

(3) Collocation Triggers

The competitive triggers that the Commission will use to decide whether to grant Phase I or Phase II relief for special access and dedicated transport services take into account the degree to which competitors have collocated their facilities within the MSA. The degree of collocation offers a guidepost for determining whether there is a competitive presence sufficient to restrain a price cap LEC's incentives to charge unreasonable rates. The Commission found that, for special access and dedicated transport services, the presence of operational collocation arrangements provided the most reliable, verifiable, and available indicator of competitive pressure within the MSA. *Order* ¶¶ 78-87 (JA 272-280). The Commission concluded that "collocation by competitors in incumbent LEC wire centers is a reliable indication of sunk investment by competitors." *Order* ¶ 81 (JA 275-76). The Commission evaluated relevant economic literature and determined that "irreversible or 'sunk' investment in facilities used to provide competitive service is the appropriate standard for determining whether pricing flexibility is warranted." *Order* ¶ 79 (JA 273-74). "In telecommunications, where variable costs are a small fraction of total costs, the presence of facilities-based competition with significant sunk investment makes exclusionary pricing behavior costly and unlikely to succeed." *Order* ¶ 80 (JA 274-75). The Commission explained that the presence of collocation arrangements indicated significant financial investment. *Order* ¶ 81 (JA 275-76).

The Commission considered other proposed triggers, and concluded that none was preferable to the collocation triggers it selected. *Order* ¶ 87 (JA 279-80). In particular, the Commission rejected proposals that, in order to receive pricing flexibility, LECs must demonstrate that they no longer possess market power in the provision of the relevant access service – the test the Commission has used to make dominant/non-dominant determinations. *Order* ¶ 90 (JA 281-82). The Commission noted that such showings were burdensome and controversial, and that the costs of delay that would result from requiring such showings outweighed the costs of granting the limited pricing flexibility at issue without such a showing. *Order* ¶¶ 90, 151-152 (JA 281-82, 310). The Commission also rejected proposals that would have required LECs to show that they had lost market share to competitors. *Order* ¶ 103 (JA 289). The Commission noted that such data was not presently available, and it declined to defer granting pricing flexibility until it was. *Id.*

The Commission established a different trigger for Phase I pricing flexibility[17] for common line and traffic-sensitive services and the traffic-sensitive components of tandem-switched transport service.[18] That trigger considers the extent to which competitors offer service primarily or exclusively over their own facilities to ILEC customer locations within the MSA. *Order* ¶¶ 108, 113 (JA 291, 293). Competitors must actually offer service to a 15 percent of ILEC customer locations to satisfy the trigger. *Order* ¶ 120 (JA 296).[19]

The Commission established this separate trigger because it found that it could not look solely to the degree of collocation to determine whether there was sufficient competition for common line and traffic-sensitive services to constrain the ILEC's prices. Competition for those

[17] As noted above, the Commission has not established triggers for obtaining Phase II relief for common line and traffic-sensitive services.

[18] We hereafter use the phrase "traffic-sensitive services" to include the traffic-sensitive components of tandem-switched transport service.

[19] The trigger is not met if competitors are merely capable of offering service. On the other hand, the trigger does not require the price cap LEC to demonstrate that competitors actually provide service to a certain percentage of customers. *Order* ¶ 120 (JA 296).

services was more recent than competition for shared access and dedicated transport, and the Commission could not predict that it would develop in the same manner. *Order* ¶ 110 (JA 292). Thus, the Commission found that it needed to account for the possibility that market entry would occur via "competitors that have wholly bypassed incumbent LEC facilities as well as competitors that collocate in incumbents' wire centers so as to provide service over unbundled loops." *Id.* The Commission concluded that there was sufficient evidence of sunk investment by competitors to warrant Phase I pricing flexibility if they provided common line or traffic-sensitive services "either entirely over their own facilities or by combining unbundled loops with their own switching and transport...." *Order* ¶ 112 (JA 292).

III. Forbearance Order

Several BOCs filed petitions for forbearance, pursuant to 47 U.S.C. § 160, while the *Pricing Flexibility* proceeding was pending. They asked the Commission to forbear altogether from applying tariff filing requirements and price cap regulation to high capacity special access and dedicated transport services in specific MSAs. On November 22, 1999, after the Commission had adopted the *Pricing Flexibility Order* granting all price cap LECs substantial relief from regulation, the Commission denied the requests for forbearance. *Petition of U S WEST Communications, Inc. for Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA*, Memorandum and Order, 14 FCC Rcd 19947 (1999) (*U S West Forbearance Order*). That decision also is the subject of petitions for review before this Court, which will be heard by the same panel that will hear this case and on the same day. *AT&T Corp. v. FCC*, Nos. 99-1535 and 00-1090.

SUMMARY OF ARGUMENT

The Commission established rules that provide additional pricing flexibility to LECs that are subject to price cap regulation. The Commission determined that, in light of the 1996 Act, which significantly increases opportunities for competition in the local exchange and exchange access markets, the Commission should offer price cap LECs additional flexibility to respond to competition. The Commission recognized that continuing to impose regulations that were no longer necessary was contrary to the public interest because unnecessary regulations perpetuate inefficiencies in the market and interfere with the development and operation of markets as competition develops. *Order* ¶¶ 67, 144 (JA 267-68, 307). The Commission adopted a multi-phase approach that at each step (1) provided appropriate regulatory relief in light of competitive developments, and (2) imposed (or retained) conditions to ensure that consumers were not harmed by such relief.

The Commission established predictive rules that would permit price cap LECs, in the future, to obtain additional pricing flexibility if the LECs could demonstrate that certain competitive "triggers" were satisfied. The triggers consider the extent to which competitors have invested in competitive facilities and established collocation arrangements within an MSA. The Commission determined that collocation could serve as a proxy for measuring competitive pressure on the ILEC. The Commission reasonably determined that, where competitors had significant "sunk investment" in an MSA, this competitive pressure would constrain the ILEC's incentive to set unreasonable rates.

Petitioners MCI WorldCom, Inc., AT&T Corp., Time Warner Telecom Inc. and their supporting intervenors (MCI) do not dispute that collocation facilities are a reliable measure of competitive entry. MCI contends, however, that the Commission was required to consider loss of market share before it could grant the pricing flexibility it did. MCI does not identify any statutory requirement, nor any relevant past Commission decisions, in support of its argument. MCI ignores numerous past decisions in which the Commission increased LECs' pricing flexibility, without making findings about market share. MCI argues instead that the Commission was obligated to use the same type of analysis it used in deciding whether AT&T was non-dominant. The Commission reasonably concluded that the costs associated with such market share determinations outweighed the benefits, in light of the limited relief granted and the protections it retained or added to ensure that carriers do not charge unreasonable prices.

The Commission also determined that, for certain types of service offerings, consumers would benefit from a grant of immediate pricing flexibility. The Commission permitted price cap LECs to introduce new services on a streamlined basis, so that consumers would have more rapid access to the new offerings and LECs could respond better to competitive offerings. The Commission also expanded price cap LECs' ability to charge deaveraged rates, which more accurately reflect the costs associated with serving a particular geographic area. The Commission conditioned both reforms in ways that would ensure that consumers are protected.

STANDARD OF REVIEW

In ruling upon the petitioners' challenge to the Commission's pricing flexibility *Order*, the Court's role is to determine whether the FCC acted within its authority and considered the relevant factors. *Citizens to Preserve Overton Park v. Volpe*, 401 U.S. 402, 415-16 (1971); *National Ass'n of Regulatory Utility Comm'rs v. FCC*, 737 F.2d 1095, 1140-41 (D.C. Cir. 1984), *cert. denied*, 469 U.S. 1227 (1985)(*NARUC*). "The FCC's judgment about the best regulatory tools to employ in a particular situation is ... entitled to considerable deference from the generalist judiciary." *Western Union International, Inc. v. FCC*, 804 F.2d 1280, 1292 (D.C. Cir.

1986); *see also NARUC v. FCC*, 737 F.2d at 1140-41. That is because "agency ratemaking is far from an exact science and involves policy determinations in which the agency is acknowledged to have expertise." *Time Warner Entertainment Co. v. FCC*, 56 F.3d 151, 163 (D.C. Cir. 1995) (quotation omitted), *cert. denied*, 516 U.S. 1112 (1996). The Court's role is to "patro[l] the perimeters of an agency's discretion," not to second guess the agency as to its choice among permissible solutions. *NARUC v. FCC*, 737 F.2d at 1140, particularly where, as here, several features of the Commission's action that petitioners challenge reflect predictive judgments about the regulated industry for which complete factual support is neither possible nor required. *FCC v. National Citizens Committee for Broadcasting*, 436 U.S. 775, 814 (1978).

Applying this governing standard of review, the Court should deny the petitions for review.

ARGUMENT

I. THE COMMISSION'S PRICING FLEXIBILITY DECISION WAS CONSISTENT WITH APPLICABLE LAW AND WITH PRIOR COMMISSION ACTIONS.

The Communications Act requires that rates be just and reasonable, and authorizes the Commission to prescribe regulations "as may be necessary in the public interest to carry out the provisions of this Act." 47 U.S.C. § 201(b). At the same time, the Commission is responsible for implementing the "procompetitive, deregulatory" goals of the 1996 Act. Joint Managers' Statement, S. Conf. Rep. No. 104-230, 104th Cong., 2d Sess. 113 (1996) at 1. *See also* 110 Stat. at 56 (Introductory Statement) (1996 Act is intended "to promote competition and reduce regulation"); 47 U.S.C. §§ 160, 161. The Communications Act, as amended by the 1996 Act, thus requires the Commission to consider both the public interest benefits of reducing regulations and the public interest benefits to be achieved through the continued application regulations where they remain necessary. MCI's arguments ignore many of the benefits of reduced regulation, particularly in the face of developing competition.

The Commission has long believed that, as a matter of policy, unnecessary regulations are contrary to the public interest because they impose costs on the regulated entities that are passed on to consumers. *Order* ¶¶ 89, 90, 144 (JA 281-82, 307). As competition develops in the local exchange and exchange access markets, regulatory restrictions may become counter-productive. *Order* ¶ 19 (JA 243-44). The Commission has stated that it will endeavor "to ensure that our own regulations do not unduly interfere with the operation of these markets as competition develops." *Order* ¶ 1 (JA 235).

Over the course of many years, the Commission has worked to open the interstate access market to competition and to relax regulation as competition develops. *Order* ¶ 67 (JA 267-68). *See also Access Charge Reform*, 12 FCC Rcd 16094 (¶ 63). The *Order* in this case is the logical next step in a series of decisions to reduce regulation and allow pricing flexibility. *See, e.g.*, *Order* ¶ 14 (JA 240) (since 1990, the Commission has taken "significant steps to increase the LECs' pricing flexibility and ability to respond to the advent of competition in the exchange access market"). *See also Order* ¶¶ 15-18 (JA 241-243).

MCI's claim that the Commission's decision departs from longstanding regulatory tradition is premised on several inaccurate assertions. MCI asserts that the Commission in the past has granted pricing flexibility only upon a showing of "substantial competition," and suggests that the Commission may not deviate from existing price cap regulation in the absence of such a showing. MCI Br. at 38. This assertion ignores the fact that the Commission is not required to regulate by any particular method, but instead is permitted to establish regulations it deems necessary in the public interest. 47 U.S.C. § 201(b). *See Permian Basin Area Rate*

Cases. 390 U.S. 747. 776-77 (1968) (unless applicable statute indicates otherwise. agencies are not bound to use any single regulatory method and may "make pragmatic adjustments which may be called for by particular circumstances"); *FPC v. Hope Natural Gas*. 320 U.S. 591. 602 (1944).

The transition from rate-of-return regulation to price cap regulation was itself a significant grant of pricing flexibility. and that grant did not depend on a determination that the ILECs faced "substantial" competition. *Policy and Rules Concerning Rates for Dominant Carriers*. Second Report and Order. 5 FCC Rcd 6786. In other instances. too. the Commission has reduced regulation and allowed pricing flexibility without requiring such a showing. *See. e.g.*, *Special Access Expanded Interconnection* Order. 7 FCC Rcd at 7454 n.411: *Virtual Collocation Order*. 8 FCC Rcd at 7426. 7433-34. ¶¶ 98-99. 115-117 (relying on collocation and interconnection agreements to determine whether to give ILECs flexibility to deaverage rates and offer volume and term discounts).

MCI points to the findings that the Commission required prior to declaring AT&T to be non-dominant. Those decisions are not analogous to this case. The Commission has not deregulated the ILECs. nor has it declared them to be non-dominant. as it did in the case of AT&T.[20] It has merely reduced regulation with respect to *certain services* in limited areas if *certain showings* are made. MCI's reliance on the Commission's analysis with respect to

[20] In fact. the Commission rejected several ILEC petitions requesting forbearance from regulation as "dominant" carriers with respect to special access and dedicated transport services. *U S WEST Forbearance Order, supra*.

AT&T's status as a non-dominant carrier is thus misplaced.[21] There is no merit to MCI's claim that the Commission was somehow deficient because it failed to apply the same "detailed economic analysis" in this case that it has applied in non-dominance proceedings in a different regulatory context. *See* MCI Br. at 8, 39. The Commission is not required to apply this rigorous standard to pricing flexibility proceedings, nor has it done so in the past.

The Commission reasonably determined that the limited regulatory relief it was making available did not warrant the costly, time-consuming proofs typically required in non-dominance proceedings. *Order* ¶¶ 90, 92 (JA 281-83). The Commission was justified in adopting a standard that relies on information that is currently available, reliable, and verifiable. *Order* ¶ 103 (JA 289). The Commission did not commit reversible error by choosing as one of its criteria "an easily verifiable bright-line test" that would avoid unnecessary administrative burdens. *Order* ¶ 78 (JA 273). *See also* MCI Br. at 40-41 (acknowledging that Commission need not ignore concerns of administrative convenience). Nor was the Commission required to delay granting pricing flexibility until it had a very precise measure of competitive entry. *NARUC*, 737 F.2d at 1116; *Allied Local and Regional Manufacturers Caucus v. EPA*, 2000 WL 737750, *7

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[21] MCI notes that the Commission found that AT&T remained dominant despite capital investments by competitors totalling more than $300 million. MCI Br. at 29. Even if that were a relevant comparison, there is evidence that competitive local exchange carriers have invested more than $30 *billion* in new networks since the 1996 Act was passed and are investing more than $1 billion every month in their networks. *See* ALTS' [Association for Local Telecommunications Services] Annual Message on the State of Competition in Local Telecommunications, February 2000, *An Open Letter From John Windhausen, Jr., President of ALTS*, Feb. 2, 2000 at 1 and Graphic F; http://www.alts.org/ALTSAnnual%20Report.pdf. *See also* Telecommunications @ the Millenium, The Telecom Act Turns Four, Office of Plans and Policy, FCC, Feb. 8, 2000 at 6, Figure 10; http://www.fcc.gov/Speeches/Kennard/2000/telecomatthemilleniumbw.pdf.

(D.C. Cir. 2000) (agency may rely on imperfect information that exists and is not required "to invest in resources to conduct the perfect study").

II. THE COMMISSION MADE REASONABLE PREDICTIVE JUDGMENTS ABOUT FUTURE COMPETITIVE ENTRY.

The Commission tailored its pricing flexibility rules in a manner designed to benefit consumers and permit ILECs to respond to competition. Moreover, the Commission took significant steps to protect consumers from potentially adverse consequences of reduced regulation. The Commission described both the benefits of granting pricing flexibility and the consumer protections that would be available with respect to each of the pricing flexibility rules that MCI challenges. Each of the Commission's decisions to grant regulatory relief should be evaluated with regard to (1) the extent of the relief granted, (2) the benefits of pricing flexibility, (3) the protections for consumers, (4) and the costs associated with denying LECs pricing flexibility to respond to competition. MCI's criticisms largely ignore these considerations.

A. The Decision To Offer Phase I Pricing Flexibility Was Reasonable.

The Commission's decision to permit ILECs to offer contract tariffs and volume and term discounts pursuant to "Phase I" pricing flexibility enables consumers to obtain lower rates, either through negotiation or through bulk purchases. Prior to the pricing flexibility decision, price cap LECs could lower their rates, but only if they did so throughout a study area or density pricing zone. *Order*, ¶ 122 (JA 298). With their new flexibility, price cap LECs no longer need to "choose between lowering a rate throughout the area at issue or not lowering it at all." *Id.* The Commission found that volume and term discounts encourage ILECs "to develop efficient rate structures," and also "avoid distorting the market or impeding the development of effective competition." *Order*, ¶ 126 (JA 300). Similarly, the Commission found that contract tariffs benefit access customers "because they enable incumbent LECs to tailor services to their customers' individual needs." *Order*, ¶ 128 (JA 301).

The Commission established significant protections to ensure that Phase I pricing flexibility will not harm consumers either directly or by enabling the LECs to exclude competitors. First, ILECs must continue to offer under price caps any services for which they obtain Phase I pricing flexibility. Thus, customers may be able to obtain *lower* rates, pursuant to volume and term discounts or contract tariffs, but the ILECs' ability to *increase* rates for those services is still constrained by price caps. *Order*, ¶ 122 (JA 298). MCI largely ignores this fact. For example, MCI claims that under Phase I, ILECs may offer contract tariffs that are "entirely free of price cap regulation...." MCI Br. at 18. The ability to offer contract tariffs, however, does not relieve the ILEC of its obligation to offer those same services pursuant to general schedules that remain subject to price caps. *Order*, ¶ 132 (JA 303).

Second, in order to attain Phase I flexibility, ILECs must show that "competitors have made irreversible investments in the facilities needed to provide the services at issue...." *Order* ¶ 69 (JA 268). Once competitors have made this irreversible investment, the Commission concluded, "we no longer need to protect competition from exclusionary pricing behavior by incumbent LECs because efforts to exclude competitors are unlikely to succeed." *Order* ¶ 77 (JA 272). The Commission observed that "in the past, the presence of an operational collocation arrangement in a wire center almost always implied that a competitor has installed transmission facilities to compete with the incumbent." *Order* ¶ 82 (JA 276). MCI does not disagree that collocation facilities indicate the presence of a potential competitor. MCI Br. at 28 (existence of collocation indicates "the presence of a single, potential competitor").

Third, the Commission requires the ILEC to show that, in each wire center relied on by the ILEC in its petition for pricing flexibility for special access and dedicated transport, at least one competitor is obtaining transport from facilities of a carrier other than the ILEC. *Order* ¶ 82 (JA 276-77). This requirement provides additional assurance that competitive transport facilities exist within the applicable MSA. The Commission imposed this additional protection because it recognized that, with the "advent of services such as digital subscriber line (DSL) services," carriers might have an incentive to collocate for reasons other than providing transmission in competition with the ILEC. *Id.*

Fourth, the Commission noted that price cap LECs still have an obligation to charge just and reasonable rates, and that their rates are subject to challenge pursuant to sections 201 and 208 of the statute. *See, e.g., Order* ¶¶ 127, 131 (JA 300-01, 302-03). These remedies are not inconsequential, as MCI suggests. MCI Br. at 42-43.[22] The Commission's enforcement procedures constrain the ILECs' freedom to establish unreasonable rates at the outset, and can award damages when rates are successfully challenged.[23] MCI argues that the Commission "has never before relied on the mere existence of a complaint procedure as the sole bulwark" against a company with market power. MCI Br. at 43. But, as set forth herein, the complaint procedures are only one of a myriad of protections to alleviate concerns about market power abuse.

[22] In fact, long distance carriers recently argued to this Court that the Commission's enforcement procedures subject carriers to "'damages as well as fines and penalties.' 47 U.S.C. §§ 206-208, 501-03 (1994)." *American Public Communications Council v. FCC*, No. 99-1114 (D.C. Cir. June 16, 2000) slip op. at 10.

[23] Carriers that knowingly charge unjust or unreasonable rates are subject to additional penalties. 47 U.S.C. § 202(c).

Fifth, ILECs must make their volume and term discounts "available to any customer with sufficient volumes or willing to commit to a given term." *Order* ¶ 124 (JA 299). Similarly, ILECs must make their contract tariffs available to all similarly situated parties. *Order*, ¶ 130 (JA 302). The Commission also imposed an additional check to make sure that ILECs do not offer contract tariffs in an exclusionary manner: An ILEC may not offer a contract tariff to an affiliate until an unaffiliated customer purchases service pursuant to that contract. *Order*, ¶ 129 (JA 301-02).

Finally, the Commission eliminated the low-end adjustment mechanism for ILECs that qualify for and obtain Phase I or Phase II pricing flexibility. *Order* ¶ 162 (JA 314). The low-end adjustment enables price cap carriers to increase their caps if their earnings fall below a prescribed rate of return. *Order* ¶ 160 (JA 313-14). The Commission recognized that, as the demand associated with non-price cap services increases (as it likely will once an ILEC obtains Phase I or Phase II pricing flexibility), the ILEC has an incentive to underallocate the costs of its non-price cap services. *Order* ¶ 163 (JA 314-15). By eliminating the low-end adjustment mechanism, the Commission significantly reduced the incentives to misallocate costs.

B. The Decision To Offer Phase II Pricing Flexibility Was Reasonable.

The Commission concluded that it should allow even greater pricing flexibility with respect to a limited set of services – special access and dedicated transport – upon a showing that "competitors have established a significant market presence, *i.e.*, that competition for a particular service within the MSA is sufficient to preclude the incumbent from exploiting any monopoly power over a sustained period." *Order* ¶ 141 (JA 306). The Commission found that retaining the Part 69 rate structure where and when it was no longer necessary "can impose costs on an incumbent LEC by limiting its ability to develop rate structures in response to market forces." *Order* ¶ 144 (JA 307). The Commission held that "retaining the Part 69 rate structure imposes costs on society by perpetuating inefficiencies in the market for interstate access services." *Id.* The Commission concluded that ILECs should be free to compete against competitors once the Phase II triggers are satisfied, and that the market, rather than regulation, would work best "in setting efficient rate levels and rate structures." *Order* ¶ 154 (JA 311).

The Commission also took steps to protect consumers under the relaxed Phase II regime. First, ILECs must continue to file generally available tariffs. *Order* ¶¶ 151, 153 (JA 310-11).[24] The Commission pointed out that the relief offered under Phase II was not equivalent to non-dominant treatment, because of the tariff filing requirement and because relief was granted only with respect to a limited area rather than on a nationwide basis. *Order* ¶ 151 (JA 310).

Second, in order to obtain Phase II flexibility, ILECs must show that competitors have established a "significant market presence" and that "IXCs have a competitive alternative for dedicated transport facilities needed to reach the majority, although not necessarily all, of their local customers throughout the MSA, and that almost all special access customers have a competitive alternative." *Order* ¶¶ 141-142 (JA 306). These triggers "are sufficient to ensure that incumbent LECs cannot exercise any remaining monopoly power indefinitely." *Order* ¶ 144 (JA 307). The Commission found that, if an ILEC attempted to charge an unreasonably high rate

[24] This enables the Commission to review and potentially suspend the rates before they take effect. 47 U.S.C. § 204(a)(1). As a practical matter, the Commission will be limited in its ability to suspend tariffs before they take effect because they are subject only to one day's notice. The Commission has, however, exercised its authority to suspend a tariff filed on one day's notice. *See Interexchange Carrier End-User Charges to Recover Universal Service Contributions*, Suspension Order, 14 FCC Rcd 20032 (Competitive Pricing Division, Common Carrier Bureau 1999).

for a part of the MSA that lacks a competitive alternative, such behavior would induce competitive entry, which in turn would restore rates to reasonable levels. *Id.* Third, the Commission required the ILEC to show that, in each wire center relied on by the ILEC in its petition for pricing flexibility, as least one competitor is obtaining transport from a carrier other than the ILEC. 47 C.F.R. § 69.711(c).

Fourth, even after obtaining Phase II relief, carriers remain subject to statutory obligations to charge just, reasonable and nondiscriminatory rates. 47 U.S.C. §§ 201(b), 202(a). Parties may challenge an ILEC's tariff filing, and they may bring complaints pursuant to the Commission's enforcement procedures. As noted above, these provisions constrain the ILEC's incentive to charge unreasonable prices at the outset, and help ensure that any unreasonable charges that become effective do not continue. Finally, as noted above, carriers that obtain Phase II pricing flexibility must relinquish the protection afforded by the low end adjustment mechanism. *Order* ¶ 162 (JA 314).

C. The Commission Reasonably Relied on Collocation Arrangements as Indicia of Competition.

The Commission established two alternative collocation "triggers" for ILECs seeking pricing flexibility for special access and dedicated transport services.[25] The Commission determined that these triggers provided a reasonable indication that competitors have made capital investments significant enough to alleviate concerns about anticompetitive pricing by the ILECs. The Commission found that carriers collocated for the purpose of providing service in

[25] The requirement for obtaining Phase I pricing flexibility for common line and traffic-sensitive services is different from the trigger for obtaining pricing flexibility for special access and dedicated transport services. Pricing flexibility for common line and traffic-sensitive services requires a showing that competitors are actually offering service to 15 percent of the ILEC's customer locations within the MSA. *Order* ¶¶ 108, 119-120 (JA 291, 295-96).

competition with the LEC and that the presence of operational collocation arrangements is a good indicator of competitive entry. The first method considers whether there are collocation facilities in a certain percentage of wire centers within the MSA for which the ILEC seeks pricing flexibility. The second method looks at whether there are collocation facilities in wire centers accounting for a certain percentage of the ILEC's revenues for the services for which the ILEC seeks pricing flexibility within the MSA. MCI objects to these triggers on several grounds.

1. MCI argues that Phase I and Phase II pricing flexibility permits deregulation without any showing that competitors have acquired a substantial share of the market. MCI Br. at 28, 30, 31, 38, 39. MCI's argument is premised on two false assumptions. First, it assumes that the Commission "deregulated" the ILECs and gave them the equivalent of non-dominant status. Second, it assumes that the Commission was required to apply the evaluation criteria in this case that it has applied to petitions for non-dominance. As explained above, the Commission did not deregulate the ILECs but in fact retained tariffing and other requirements to restrain abuse of market power. Moreover, the Commission explained and justified its decision not to rely on market share.

The Commission determined that the presence of collocation facilities was a reliable indicator "that there is irreversible investment sufficient to discourage exclusionary pricing behavior...." *Order*, ¶ 78 (JA 272-73). MCI does not meaningfully address the Commission's determination that collocation facilities are a reliable indicator of competitive pressures. In fact, MCI acknowledges that collocation arrangements indicate the presence of a competitor, but claims that such facilities do not demonstrate that competitors have a significant market share in that wire center. MCI Br. at 28.

The Commission's reliance on collocation facilities was reasonable. The Commission found (and MCI does not dispute) that "competitors incur considerable expense to establish an operational collocation arrangement." *Order*, ¶ 81 (JA 276). In addition to the significant financial outlays necessary to establish collocation facilities, competitors spend substantial time and resources to negotiate collocation agreements. *Id.* Competitors go to this expense and expend these resources for the purpose of providing competitive service. Looking to the presence of collocation arrangements, moreover, represents a reliable and relatively simple way to evaluate whether competitive pressures exist. *Order*, ¶ 84 (JA 277-78). The Commission found that other potential indicators of competition – such as satisfaction of an extensive checklist modeled on section 271 of the Act, 47 U.S.C. § 271(c)(2)(B), which governs BOC entry into long distance service -- are costly and difficult to verify and not necessary to the task at hand. *Id.*

MCI contends that the existence of collocation arrangements in itself does not demonstrate that there is significant competition. MCI's argument is inapposite because it equates competitive pressure with market share. But the Commission did not conclude that a loss of market share was necessary to constrain an ILEC's prices. To the contrary, the Commission found that the presence of substantial sunk investment by a competitor imposes restraints on anticompetitive behavior. The Commission noted:

> Another firm can buy the facilities at a price that reflects expected future earnings and, as long as it can charge a price that covers average variable cost, will be able to compete with the incumbent LEC. In telecommunications, where variable costs are a small fraction of total costs, the presence of facilities-based competition with significant sunk investment makes exclusionary pricing behavior costly and highly unlikely to succeed.