

38. *Third*, the triggers established by the Commission in the *Pricing Flexibility Order* do not require that the evidence be consistent with the relief sought. As noted, access services are demanded and supplied on a point-to-point basis. Accordingly, the Commission must assure that the geographic scope of any request for pricing flexibility matches the geographic scope of demonstrated price-constraining competitive alternatives. Even significant competition in one part of an MSA does not protect consumers in areas where little or no such competition exists.

39. The Commission's triggers, however, do not require ILECs to show that price-constraining competition exists across the entire MSA. Instead, the triggers in effect allow an ILEC to exercise market power in substantial portions of an MSA as long as it can show that competitive entry exists in a small portion of an MSA. This approach totally ignores the point-by-point nature of the market demand for these services, and thus leaves substantial portions of an MSA susceptible to anticompetitive practices and exclusionary pricing behavior by the ILECs.

40. In the case of special access services (except channel terminations) and dedicated transport, for example, an ILEC can obtain Phase II relief as long as it can show competitors have operational collocated facilities in 50 percent of the wire centers in the MSA. In fact, the required percentage can be *significantly below* 50 percent as long as the wire centers where competitors are collocated account for at least 65 percent of the ILEC's revenues from these services. Thus, the trigger would allow broad-based pricing flexibility throughout an MSA even when there were only a limited competitive presence (one collocator) in 50 percent of wire

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a small fraction of the demand for such services. At the DS1 level – the facilities that are used economically to serve lower-usage special access customers – competition is almost nonexistent.

centers in that MSA, and no competition whatsoever existed in the other 50 percent of wire centers. Under the alternative revenue-based trigger, the ILEC can obtain relief if competition existed in only a few wire centers that accounted for the specified percentage of revenues.

41. BellSouth's recent petition for pricing flexibility for special access and dedicated transport illustrates this point. For more than 80 percent of the MSAs for which it sought pricing flexibility, BellSouth relied on the "revenue-based" alternate trigger. In some of these MSAs, competition is extremely limited and confined. Two examples are illustrative. In the Asheville, North Carolina MSA, BellSouth seeks Phase II pricing flexibility because the 11 percent of wire centers in that MSA with collocated competitors allegedly account for 75 percent of its revenues from special access and dedicated transport – even though 89 percent of the wire centers have no collocated competitor that uses its own transport. BellSouth also seeks Phase II pricing flexibility for the Gainesville, Florida MSA because 90 percent of its channel termination and special access/dedicated transport revenues are purportedly derived from wire centers where competitors have collocated facilities; yet those wire centers account for only 16.7 percent of all wire centers in the MSA.

42. Regardless of which trigger the ILEC uses as the basis for its application, the grant of pricing flexibility will leave the ILEC free to exploit its market power in those areas of the MSA where competition does not exist. Freed of price regulation, the ILEC will be free to charge monopoly rents to captive customers of special access and dedicated transport while having the ability to manipulate its rates to exclude potential competitors whenever a threat of entry arises.

43. The Phase I trigger for switched access services is similarly deficient, because it only requires an ILEC to show that competitors are offering service to at least

15 percent of customer locations in the MSA either “exclusively or largely” over their own facilities. By setting the bar so low, the trigger allows an ILEC the freedom to use contract tariffs and offer volume and term discounts throughout an entire MSA, even though facilities-based competition does not exist for as many as 85 percent of customer locations in the MSA. In those areas not subject to such competition, the ILEC will be able to practice the very anticompetitive activities that the trigger was intended to prevent.

44. BellSouth’s petition for pricing flexibility for switched access services is again illustrative. According to an October 31, 2000 *ex parte* letter to the Commission from BellSouth, in five of the ten MSAs for which pricing flexibility is requested, “facilities-based” competitors (as defined by BellSouth) offer switched access to no more than 15.4 percent of customer locations (and in one of these MSAs, only 6.1 percent of customer locations are offered service). Only in three of the 10 MSAs are more than 40 percent of the customer locations offered service by purportedly “facilities-based” competitors – and even in those MSAs, the percentage of customer locations in noncompetitive areas is substantial (58.9 percent in one MSA, 51.9 percent in the second, and 27 percent in the third).<sup>17</sup> The existence of competition in the limited areas of these MSAs cannot constrain anticompetitive behavior in other areas where competition does not exist.

45. *Fourth*, the Commission’s triggers fail to take into account the extent to which the ILEC seeking Phase I or Phase II pricing flexibility has taken advantage of the pricing

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<sup>17</sup> The percentages that are set forth in the October 31 BellSouth *ex parte* letter were recalculated from those set forth in Attachment 1 of BellSouth’s original petition, which were substantially higher for several of the MSAs because BellSouth had misinterpreted the *Pricing Flexibility Order* as allowing it to include in the percentages the activities of CLECs who relied on BellSouth as the source of their transport. When that error was corrected by BellSouth, a very different competitive picture emerged. Indeed, for four of the 10 MSAs, the recalculated percentages were below the 15 percent threshold that must be met for Phase I relief. Even the percentages in BellSouth’s original petition showed that large portions of the 10 MSAs were noncompetitive; for example,

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flexibility already granted by the Commission. In the *Pricing Flexibility Order*, the Commission explicitly rejected the notion that the failure of an ILEC to adjust rates under the geographic deaveraging then permitted and the existing price cap rate structure is not an indication of the lack of meaningful competition. The Commission reasoned, in essence, that its existing pricing rules limited the ILECs' ability to respond to competition. *Pricing Flexibility Order*, ¶¶ 66, 92. That explanation, however, is insufficient from an economic perspective. Despite their limitations on pricing behavior, the existing FCC rules (including the revised rules promulgated in the *Order*) give the ILECs some flexibility to change prices in response to competitive forces. For example, ILECs generally can charge any price for access services as long as the price does not exceed the applicable price cap ceiling; can engage in certain forms of geographic deaveraging; and can offer volume and term discounts under certain conditions. The failure of a CLEC to take advantage of this pricing freedom can be compelling evidence that no effective competitive constraints on the ILEC's prices currently exist.

46. For example, BellSouth has consistently priced its access services – whether special access services and dedicated transport or switched access services – at or near price cap levels, even though it was free to charge lower rates. Stock Declaration, ¶¶ 5, 10. BellSouth also has failed to take advantage of the flexibility to deaverage special access and dedicated transport rates, and tandem-switched transport rates, into seven zones per study area, which the *Pricing Flexibility Order* permits without the need to obtain Commission approval. Instead, BellSouth's rates are identical (or virtually identical) in all three of its rate zones. *Id.*, ¶¶ 6, 11. This behavior is difficult to reconcile with BellSouth's current claims that market

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according to Attachment 1 of the petition, in three MSAs no more than 18.7 percent of customer locations were offered service by "facilities-based" competitors (as defined by BellSouth).

forces will constrain its prices for access services to competitive levels even in the absence of regulation, since historical-based price cap levels are generally conceded to be well above forward-looking costs. It is reasonable to infer from its pricing behavior that BellSouth is not subject to effective competition throughout the MSAs for which it seeks pricing flexibility relief. The fact that BellSouth, in the face of these realities, could be granted the relief it seeks would not be in the public interest.

**II. Because of Their Failure to Follow Fundamental Methodological Principles, the Triggers in the *Pricing Flexibility Order* Will Enable Price Cap LECs Who Are Granted Pricing Flexibility To Inflict Irreparable Harm on Competitors, Purchasers of Access Services, and End-User Customers.**

47. If the incumbent LECs are awarded pricing flexibility under the circumstances contemplated by the Commission's triggers, the predictable effect will be to essentially freeze competitive entry into the access market at present levels, while simultaneously allowing the incumbents to raise their generally applicable rates to monopoly levels without regulatory restraint. This would result in several forms of irreparable harm, to competitors, to purchasers of access services, and to end user customers.

48. Consistent with the pro-competitive objectives of the 1996 Act, the Commission should develop policies that encourage competition, and efficient competitive entry, in the markets for access services to the maximum extent possible. Competition in these markets will benefit purchasers of access services and end-user customers, because the entry of additional efficient access providers is likely to lead to the availability of lower prices and improved service.

49. Even the limited entry of alternative access providers into the access markets to date illustrates the benefits that competition can bring. In a few states in the

BellSouth region, some new entrants offer rates for switched access services that are below BellSouth's. See Stock Declaration, ¶ 12.

50. Competition in the access markets, however, is still in its incipiency. In many areas, competition is either nonexistent or only slowly beginning to develop. The nascent stage of competition is reflected in BellSouth's two petitions for pricing flexibility, which effectively concede that competitive alternatives exist only in a relatively small percentage of wire centers (in the case of special access and dedicated transport) and for a limited number of customer locations (in the case of switched access).

51. Moreover, in the context of switched access services, the entry of an alternative provider will not, by itself, result in lower rates or a constraint on BellSouth's pricing. As this Commission has recognized, CLECs – like ILECs – possess powerful locational advantages that insulate their rates from competitive pressures that might otherwise restrain their pricing for switched access services.<sup>18</sup> The ability to charge high access rates confers an enormous advantage on any LEC. It therefore cannot be assumed that CLECs offering switched access will offer competitive rates or exert competitive pressures on price cap LECs. The fact that some (but far from all) existing alternative providers of switched access nonetheless have chosen to offer lower rates is all the more reason to encourage maximum possible entry into the market for switched access, for numerous potential and actual entrants are assured to push rates lower than those charged by the ILEC.

52. As explained in Part I, the triggers established by the *Pricing Flexibility Order* would not promote competitive entry into the access markets, because they do not provide sufficient assurances that ILECs will lack market power over the access services involved. As a

result, if ILECs such as BellSouth are granted pricing flexibility like that authorized in the *Pricing Flexibility Order*, competitive entry into the access market will be deterred beyond the little entry that has already occurred, and purchasers of access services such as AT&T will be forced to pay monopoly access rates to the ILECs, resulting in higher rates to end-user customers.

1. **Predatory Pricing**

53. As the Commission recognized in the *Pricing Flexibility Order*, the characteristics of telecommunications markets give incumbent LECs the ability to engage in exclusionary pricing practices against new entrants. In the absence of regulatory restraints, incumbents have the ability to ward off the threat of competitive entry by “locking up” large customers by offering them volume or term discounts below entrants’ costs – thereby deterring prospective entrants, for whom service to large customers may have been the inducement necessary to invest in the necessary sunk facilities. In particular, the incumbents have the ability to effectuate a price squeeze against access rivals – *i.e.*, since new entrants in the access market rarely provide service over their own facilities on an end-to-end basis, in the absence of regulatory constraints the incumbent can raise the price of the input upon which the new entrant is relying (e.g., channel terminations), while setting the price of the end-to-end service at an exclusionary level. *Pricing Flexibility Order*, ¶ 79.

54. The granting of pricing flexibility to ILECs will give them the ability to engage in such anticompetitive conduct. Phase I relief will enable the ILEC to offer volume and term discounts and contract tariffs to customers (as long as those tariffs are generally available to

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<sup>18</sup> First Report and Order in *Access Charge Reform*, CC Docket Nos. 96-262, *et al.*, ¶¶ 359-364 (released May 16, 1997) (“*Access Reform Order*”).

similarly situated customers). Phase II relief, of course, will eliminate price caps, which protected access customers from monopoly rates. Moreover, the *Pricing Flexibility Order* removes some of the preexisting limitations on geographic deaveraging (which guard against predatory pricing and price discrimination).

55. In short, Phase I and Phase II relief will enable an ILEC to exploit and maintain its market power through a combination of predatory pricing and monopoly pricing. In those areas where the incumbent faces the threat of entry by competitive providers of switched or special access services, the Phase I relief will give the ILEC the ability and incentive to offer individualized and targeted prices well below those of its competitors – perhaps below applicable costs – for the short run, until effective competition is no longer a threat. To the extent that the competitor depends upon the ILEC as the source of one or more critical inputs needed to provide the access service (such as channel termination or dedicated transport), the ILEC will have the ability and incentive to increase the prices of the inputs in order to impose significant additional costs on its competitors.

56. As a result of these practices, alternative providers of access services will experience a substantial impairment of their ability to offer effective competition to the ILEC. In the case of a competitor that relies on the ILEC for certain critical inputs, the adverse consequences of the ILEC's predatory pricing would likely be severe. In such circumstances, the competitor would have no choice but to curtail all further expansion of facilities, because it would know that the incumbent could execute an anticompetitive price squeeze before the new entrants could build the necessary facilities.

57. Thus, as a result of the ILEC's pricing behavior, future competitive entry into the market would be deterred, and the market would be deprived of additional alternative

access providers – to the detriment of customers of access services and end-user consumers. No reasonable entrepreneur will enter a market if it believes that it has no prospect of recovering its investment, and making at least a competitive return, in the long run. Upon the entry of any new alternative provider of access services, however, the ILEC would respond with the same pattern of predatory pricing – and the alternative provider would sustain the same losses as those that would predictably be sustained by existing alternative access providers. The likelihood of such losses would surely deter prospective entrants from entering the market as facilities-based providers, because they would have no prospect of recovering the substantial sunk investment in equipment that they would be required to make. Companies that would depend on the ILEC for critical inputs would, if anything, be even more unwilling to enter the market, because the likelihood of losses would be enhanced by the unreasonable prices that they would be required to pay to the ILEC for those inputs.

58. The deterrence of additional access providers will deprive both purchasers of access and end-user customers the opportunity for lower prices and better service. Neither new entrants nor purchasers of access services have an obvious remedy for such harms. The Commission's pricing flexibility rules would have the perverse effect of choking off the development of competition, but it would be almost impossible through post hoc legal remedies to put new entrants, purchasers of access, and the public at large in the position in which they would have been had the Commission permitted competition to proceed.

## 2. Monopoly Pricing

59. In those areas where competition for access services does not exist, an ILEC granted pricing flexibility would have the ability and incentive to raise its access charges above price cap ceilings in those MSAs for which Phase II relief has been granted. In areas currently without competition, the ILEC could implement the price increase as soon as its

petition for pricing flexibility was approved. In those areas where competition currently exists, the ILEC could begin to charge supra-competitive prices for access services as soon as its predatory pricing practices had rendered the alternative providers incapable of providing effective competition.

60. The assessment of monopoly prices for access by ILECs will inflict irreparable harm on access purchasers and their customers. Typically, purchasers of special access services and dedicated transport and of switched access services are interexchange carriers, such as AT&T, who require access to transmit the call from a customer's premises to the IXC's point of presence or from the IXC's point of presence to the customer. Access services are an essential input for an IXC's long-distance service because, without them, an IXC can neither terminate nor originate a customer's long-distance calls.

61. The long-distance market is characterized by intense competition. Thus, the IXC would have little choice but to pass on the rate increase to its end-user customers by increasing its charges for long-distance services. That increase, however, will likely cause long-distance customers to reduce their usage of long-distance. As a result of the decrease in demand, the IXC will lose revenues and customers. By contrast, because no alternative access providers are available, the ILEC will earn higher profits from the monopoly rates paid by its captive access customers than would have been the case under the price cap regime.

62. By virtue of its incumbency and ubiquity of service, an ILEC with Phase I and Phase II pricing flexibility could deter future entry in non-competitive areas of an MSA without even lowering its rates below (possible) monopoly levels. To see how this could be accomplished, assume that some monopolistic portions of a state or MSA are presently unattractive to a potential entrant. This might be so because demand for access in these parts is

not sufficiently high to warrant or support more than one access provider. However, some other parts of the state or MSA could potentially sustain competition. Assume that the ILEC has sunk all the costs necessary to provide the access services on an statewide basis. The entrant, however, must sink some costs to provide that service and would be willing to do so only if it faced some real possibility of recouping its investment on a forward-looking basis. However, the ILEC can deter such investment by making clear that it will offer customers who require access at two sites – one in a monopolistic part of the MSA, and the other in a potentially competitive part of the MSA – the following contract: “If you purchase service at one site from me at the market price, I will provide you with the second site at (incremental) cost.” The prospect of such an offer can deter entry and maintain the price of access at the monopoly level. This is because the entrant, who can only economically serve one site, realizes that if it enters, the incumbent is essentially committed to give away the service in the competitive area. Such an entrant cannot reasonably recover its sunk costs and would thus abstain from coming into the market – which would leave the ILEC able to charge the total monopoly price at both sites, with entry still foreclosed. For the same reasons, including economies of scale and scope, an ILEC could deter a prospective entrant who desires to provide service only in a single, non-competitive portion of the MSA merely by threatening to charge a low price to access customers in that area.

63. The incentive of ILECs such as BellSouth to charge monopoly prices for access rates will, if anything, be even greater once they are permitted to provide in-region long-distance services under Section 271 of the 1996 Act. Two ILECs have already received such approval from the Commission to provide such services in two states (Verizon in New York and SBC in Texas). Further, BellSouth has represented to the media that it will seek Section 271 authority for one of the states in its region during the first or second quarter of 2001 – and, once

that application is approved, BellSouth may file similar applications for the other states in its region.

64. Once it has Section 271 authority, the ILEC would have the incentive and ability to engage in an anticompetitive price squeeze as long as it remains a monopoly (or near-monopoly) provider of access services. Once ILECs such as BellSouth are permitted to provide in-region long-distance service, they will be competing with the IXCs that depend on them for the provision of terminating and originating access. This will provide the ILECs – which, with the grant of pricing flexibility, already had the ability and incentive to increase access charges to enhance their profits – with the further opportunity and incentive to weaken the IXCs’ competitive position by overcharging them for access. At the same time, the increase in access charges will provide the ILECs’ long-distance affiliates with a strategic cost advantage wholly unrelated to any efficiencies realized by the affiliates. The source of these cost and competitive advantages is the difference between the true cost of access, as measured by its total element long-run incremental cost (“TELRIC”), and the distorted rate that the ILEC can charge to its access customers. This cost advantage would enable the ILEC not only to charge monopoly prices for access, but to set its long-distance rates at or below its access prices.<sup>19</sup>

65. If access prices are above the costs that the ILEC actually incurs to provide access, the ILEC can use the cost differential between what its rivals pay them for these

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<sup>19</sup> The Commission has long recognized that, “[a]bsent appropriate regulation, an incumbent LEC and its interexchange affiliate could potentially implement a price squeeze once the incumbent LEC began offering in-region, interexchange toll services.” *Access Reform Order*, ¶ 277; see also *id.* ¶ 278 (incumbent LECs have the “incentive and ability to engage in a price squeeze”). As the Commission has explained, “[t]he incumbent LEC could do this by raising the price of interstate access services to all interexchange carriers, which would cause the competing in-region carriers to either raise their retail rates to maintain their profit margins or to attempt to maintain their market share by not raising their prices to reflect the increase in access charges.” *Id.* ¶ 277. Alternatively, “the incumbent LEC could also set its in-region, interexchange prices at or below its access prices. Its competitors would then be faced with the choice of lowering their retail rates for interexchange services, thereby reducing their profit margins, or maintaining their retail rates at the higher price and risk losing market share.” *Id.*

elements and the lower economic cost that it incurs as a vertically integrated company to create an anti-competitive price squeeze and artificially gain an advantage in the provision of bundled services. This strategy will be profitable to the ILECs, while harmful to consumers, and will weaken the ability of IXCs to compete for local exchange business while maintaining the monopoly hold that the ILECs have over that business.

66. Thus, if granted pricing flexibility and Section 271 authority, ILECs will predictably use price-squeezing tactics to inflict even greater harm on IXCs and consumers. Price squeezing would impair the IXCs' ability to compete for the provision of local and long-distance service and the provision of bundles of telecommunications services that include long-distance and local exchange services. Protecting their profits from access and garnering excessive margins on bundled services jointly provide a powerful set of incentives to the ILECs to disadvantage their long-distance competitors. By maintaining above-cost access charges, the ILEC can continue to apply strong financial pressure on the IXCs, who must charge customers the levels of prices for long-distance service that reflect the excessive charges. By charging prices to its own long-distance customers that do not reflect all of the high access prices, the ILEC will be able to divert substantial business from the IXCs to itself.

67. This vertical squeeze tactic would be detrimental not only to IXCs, but also to telecommunications consumers. At first glance, it may appear that the effects of the tactic fall only on the ILEC's long-distance and bundle *competitors* who will have to match (or undercut) the ILEC's prices in order to gain or maintain market share. In fact, these misincentives have adverse impacts on *consumers*. As long as the ILEC continues to charge and collect above-cost access prices, it is the end users who will continue to pay for them in one way or another. One avenue is simply the passed-along amount that the end-user pays to the IXC, so

that the IXC can in turn pay it to the ILEC. Another avenue is the above-cost price for long-distance charged to the end-user by the ILEC. Both of these avenues of payment stand in stark and dramatic contrast to the wished-for competitive scenario in which the ILEC and IXCs compete to offer the end-user attractive bundles of services at prices which reflect no above-cost margins arising from monopoly rents.

68. Regulation will not prevent an ILEC with price flexibility and Section 271 authority from engaging in anticompetitive price squeezes. In particular, the separate affiliate and imputation requirements of Section 272 of the 1996 Act do not sufficiently eliminate competitive concerns. The requirement of Section 272(e)(3) that an RBOC impute to itself the same cost of access as it charges to its IXC competitors, while eliminating the most transparent form of discrimination, does not remedy the underlying problem of anticompetitive incentives and ability nor necessarily stop less transparent forms of access price discrimination. The transfer price recorded on the affiliated enterprise's books -- whether it is equal to or different from the access charge imposed on IXCs -- is irrelevant, because the transfer of money from one pocket of the overall business to the other pocket is irrelevant. The relevant price for detecting price discrimination is composed of the incremental cost of access plus the imputed profits, neither of which can be obtained directly from an RBOC's books, whether or not there is a separate subsidiary.

69. Finally, the ability of an ILEC to use its pricing flexibility to engage in predatory and monopoly pricing will be detrimental to interexchange carriers, such as AT&T, who sell their excess transmission capacity to other long-distance carriers. Each entrant into the access market also represents a potential long-distance carrier, because carriers in today's market desire the capability of providing both local exchange service and long-distance service to their

customers. Providing long-distance service exclusively through one's own facilities, however, requires the investment of substantial sunk costs. Many carriers are unwilling, or unable, to make an investment of that magnitude. Instead, they have been able to become long-distance carriers by purchasing excess long-distance transmission capacity from AT&T and other facilities-based interexchange carriers. That is why, although facilities-based IXCs have steadily increased in number over the years, many other IXCs are providing service as resellers.

70. Thus, the deterrence of entry into the access markets would have the effect of depriving AT&T and other facilities-based IXCs of many new customers of their long-distance transmission capacity. For AT&T, this would be a substantial loss of prospective business. I understand that AT&T currently receives substantial annual revenues from sales of its long-distance capacity to resellers. Given the popularity of resale as a method of entry into the long-distance market, it can be assumed that these revenues would grow dramatically as new companies entered the market to provide both local and long-distance service.

71. In short, by enabling ILECs such as BellSouth to engage in a combination of predatory pricing and monopoly pricing, the pricing flexibility permitted by the *Pricing Flexibility Order* would cause substantial harm to access purchasers, alternative access providers, and consumers. Such anticompetitive pricing behavior will:

- Deter additional entry into the markets for special access and dedicated transport and for switched access services, even though existing competitive alternatives in both markets are insufficient to act as a constraint on ILECs' pricing of access services.
- Severely impair the competitive abilities of existing alternative access providers, and perhaps cause the exit of some of these providers from the market.
- Increase access charges to monopoly levels, impairing the ability of interexchange carriers to compete in the long-distance market and raising long-distance rates for consumers.
- Deprive facilities-based IXCs of the opportunity for new markets for long-distance transmission capacity.

**III. CONCLUSION**

72. For the reasons stated, the triggers established by the *Pricing Flexibility Order* fail to ensure that, absent regulation, an ILEC granted such flexibility would be unable to exercise market power over the access services for which pricing flexibility is authorized. Instead, the triggers enable an ILEC to engage in exclusionary pricing behavior, increase rates to unreasonable levels for customers that lack competitive alternatives, and deter efficient entry into the access markets. Far from fostering competition, a grant of pricing flexibility under the Commission's current triggers will deprive the access markets of new entrants, impair the competitive abilities of alternative access providers and access customers, increase prices to consumers, and deprive interexchange carriers of additional potential markets for their excess long-distance transmission capacity. Such consequences are plainly contrary to the public interest.

I declare under penalty of perjury that the foregoing is true and correct to the best of my knowledge, information, and belief.

Executed on this 20<sup>th</sup> day of November, 2000.

  
Robert D. Willig

## CERTIFICATE OF SERVICE

I hereby certify that on this 21st day of November, 2000, I caused true and correct copies of the foregoing Motion of AT&T Corp. for Stay of Pricing Flexibility Order Pending Judicial Review to be served on all parties by first class mail, postage pre-paid to the addresses on the following service list.

  
Charissa N. Stroup

## SERVICE LIST

Magalie R. Salas  
Federal Communications Commission  
445 12<sup>th</sup> Street, SW  
Washington, D.C. 20554

ITS  
445 12<sup>th</sup> Street, SW  
Washington, D.C. 20554

Mark L. Evans  
Rachel E. Barkow  
Kellogg, Huber, Hansen, Todd & Evans  
1615 M Street, NW, Suite 400  
Washington, D.C. 20036

M. Robert Sutherland  
BellSouth Telecommunications, Inc.  
1155 Peachtree Street, NE  
Atlanta, GA 30306-3610

Dan L. Poole  
Robert B. McKenna  
James T. Hannon  
Jeffrey A. Bruggeman  
Qwest International, Inc.  
1020 19<sup>th</sup> Street, NW, Suite 700  
Washington, D.C. 20036

James D. Ellis  
Alfred G. Richter  
SBC Communications, Inc.  
175 E. Houston  
San Antonio, TX 78205

Roger K. Toppins  
Hope E. Thurrott  
Charles B. Scharnberg  
SBC Communications, Inc.  
1401 I Street, NW, Suite 1100  
Washington, D.C. 20005

Michael E. Glover  
Edward Shakin  
Verizon Communications  
1320 North Court House Road  
Arlington, VA 22201

Carol Ann Bischoff  
Jonathan Lee  
Competitive Telecommunications  
Association  
1900 M Street, NW, Suite 800  
Washington, D.C. 20036

Lawrence E. Sarjeant  
Linda L. Kent  
Keith Townsend  
John W. Hunter  
Julie E. Rones  
United States Telecom Association  
1401 H Street, NW, Suite 600  
Washington, D.C. 20005

Jonathan Askin  
Teresa K. Gaugler  
Telecommunication Services  
888 17<sup>th</sup> Street, NW, Suite 900  
Washington, D.C. 20006