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FEDERAL COMMUNICATIONS COMMISSION
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Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of	)	
	)	
Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers	)	CC Docket No. 00-256
	)	
Federal-State Joint Board on Universal Service	)	CC Docket No. 96-45
	)	
Access Charge Reform for Incumbent Local Exchange Carriers Subject to Rate-of-Return Regulation	)	CC Docket No. 98-77
	)	
Prescribing the Authorized Rate of Return For Interstate Services of Local Exchange Carriers	)	CC Docket No. 98-166

AT&T REPLY COMMENTS ON MAG NPRM

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TABLE OF CONTENTS

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Pursuant to the Commission's Notice of Proposed Rulemaking, FCC 00-448, released January 5, 2001, and published in 66 Fed. Reg. 7725 (January 25, 2001) ("NPRM"), and Section 1.415 of the Commission's rules, 47 C.F.R. § 1.415, AT&T Corp. ("AT&T") submits these reply comments in response to other parties' comments on the petition for rulemaking submitted by the Multi-Association Group ("MAG") for interstate access reform and universal service support for incumbent local exchange carriers ("LECs") subject to rate-of-return ("ROR" or "non-price cap") regulation. MAG has submitted its proposal to the Commission as an integrated package designed to be implemented over a five-year period commencing July 1, 2001.

INTRODUCTION AND SUMMARY

As the comments show, the MAG plan contains a number of features that, with certain modifications, could be incorporated into a much-needed plan for access reform for ROR carriers by July 1, 2001. Most importantly, the comments confirm that, as MAG recognizes, implicit subsidies need to be removed from the access charges of ROR carriers and recovered in an explicit manner through the Universal Service Fund ("USF") in the form of a RAS (rate averaging support). A number of parties point out, however, that unlike under MAG's proposal, the RAS should be required for *all* ROR carriers and ROR carriers opting for incentive regulation. The comments predominantly confirm that there is a need to increase subscriber line charge ("SLC") caps to allow for recovery of loop costs from the end user and to reduce traffic sensitive rates. Several parties concur in AT&T's suggestion that SLC caps should be increased to CALLS levels and the traffic sensitive rate should be reduced to the CALLS rate for rural carriers of $0.0095. The comments also support the fact that ROR carriers' USF obligation must be removed from carrier-paid access charges. The Commission can and should act quickly to adopt these modifications as soon as possible, in conjunction with the universal service reforms proposed by the Rural Task Force ("RTF").[1]

Various commenters agree with AT&T's demonstration that under MAG's USF proposal, additional universal service support is not linked to increased infrastructure

[1] *See Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Further Notice of Proposed Rulemaking, FCC 01-8, released January 12, 2001, and published in 66 Fed. Reg. 7867 (January 26, 2001) ("RTF FNPRM").

investment by the carrier and could cause the fund to spiral. Yet, the proponents of MAG maintain that there is a need for the increased support that MAG proposes. The best way to resolve these conflicting viewpoints is for the Commission to adopt the comprehensive package for universal service and access reform submitted by the RTF. In addition to constraining the size of the USF, the RTF proposal recognizes the need for access reform by establishing a High-Cost Fund III for recovery of universal service support currently implicit in rural LECs' interstate access charges. Using the RTF framework, the Commission should selectively incorporate those portions of the MAG proposal that would allow for efficient access rate level reform through a High-Cost Fund III (or RAS) to be implemented by July 1, 2001, while it proceeds to develop a more effective plan of incentive regulation for the non-price cap LECs.

With respect to the MAG's proposed incentive regulation plan, the comments show that allowing traffic sensitive revenues to grow based on line growth plus inflation and without any productivity offset would allow unbounded revenue growth for companies electing incentive regulation. Given the complexity of productivity issues, the Commission should consider incentive regulation in a separate phase of this proceeding.

In short, rate-of-return regulation should continue for the non-price carriers for the July 1, 2001 annual filing, by which time proposed SLC increases and a High-Cost Fund III/RAS should be in place to support a traffic sensitive rate of $0.0095. These are critical modifications necessary to sustain local competition, universal service and nationwide geographic rate averaging of long distance services. At the same time, given that these changes will increase the size of the USF, as AT&T showed, it is critical that the FCC eliminate the competitive inequity caused by the prior-year assessment mechanism of the USF

("USF lag") *prior* to adoption of the plan. The Commission should then proceed to develop a properly-constructed incentive plan in the next phase of this proceeding that would ensure that revenue growth tracks underlying cost growth and that consumers benefit from carriers' increased efficiencies.

I. THE PROPOSED ACCESS RATE LEVELS UNDER MAG NEED TO BE ADJUSTED TO CALLS LEVELS.

MAG makes a number of proposals related to access rate level issues. To the extent that these proposals would rationalize access cost recovery, the Commission should use them to fill in the RTF proposal for access reform predicated on removal of implicit subsidies and establishment of a High-Cost Fund III. These changes should be fully implemented by July 1, 2001. AT&T at 3-4; TDS at 6.

MAG (at 18) contends that it is reasonable to make implicit subsidies explicit through RAS for Path A LECs but for Path B LECs it is permissible under the Act to retain the existing universal service support structure and allow them to continue to derive support through inflated access charges. To the contrary, as AT&T (at 4) and Innovative (at 3-4) demonstrated, the access reform/High-Cost Fund III changes are required by Section 254(e) of 1996 Act. As the Fifth Circuit explained in *Alenco Communications Inc. v. FCC,* 201 F.3d 608, 615-616 (5^{th} Cir. 2000) (citations omitted): "[T]he old regime of implicit subsidies – that is, 'the manipulation of rates for some customer to subsidize more affordable rates for others' – must be phased out and replaced with explicit universal service subsidies – government grants that cause no distortion to market prices – because a competitive market can bear only the latter." As described with greater specificity below, to implement these statutory directives, the Commission needs to adjust access rates to reflect removal of implicit subsidies, convert such subsidies into explicit support and establish a competitively neutral High-Cost Fund III for their recovery.

Subscriber Line Charges. MAG proposes that SLC caps be raised to mirror those under CALLS, provided that the caps are "reasonably comparable" to SLCs charged by the LECs subject to CALLS.[2] NASUCA (at 5), however, contends that the "increase in the SLC runs counter to efficient pricing. It results in a subsidy from basic exchange services to switched access services." Texas (at 3-4) similarly challenges the consumer benefits of the plan because of higher flat-rate end-user charges. Interstate Telcom (at 14-15) contends that SLC caps should not be set equivalent to CALLS as SLC increases are perceived to be increases in local rates, which have traditionally been lower in rural areas. Contrary to these observations, WorldCom (at 8) demonstrates that the Commission expressly found in the *Access Reform Order*[3] that "increasing the SLC caps to recover a greater portion of interstate-allocated non-traffic sensitive costs is the most basic step that can be taken to eliminate implicit support." *See also* CUSC at 13-14 (SLC increase needed to eliminate implicit subsidy and recover costs from cost causer); Qwest at 2; Sprint at 6 (since MAG LECs serve rural areas, CALLS SLC caps should be the minimum). Indeed, as Global Crossing (at 4) points out, a SLC increase is pro-competitive and would introduce immediate significant consumer benefits. Moreover, but for the disparity in SLC caps created by CALLS, the SLC caps have always been uniform nationwide. Indeed, Section 254(b)(3) of the

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[2] *See Access Charge Reform, etc.,* CC Docket No. 96-262, FCC 00-193, released May 31, 2000 ("CALLS Order").

[3] *Access Charge Reform,* CC Docket No. 96-262, First Report and Order, FCC 97-158, ¶¶ 67-69; 75-77, released May 16, 1997 ("Access Reform Order").

Communications Act requires rate comparability between urban and rural areas and thus requires uniformity in the SLC caps. Accordingly, to rationalize loop cost recovery, SLC caps should be increased to CALLS levels – irrespective of the amount the CALLS LECs actually charge end users – to maximize efficient loop cost recovery from the cost causer of the loop, namely, the end user. AT&T at 5. For the same reason, as WorldCom (at 8) shows, the multiline business SLC cap should be increased from \$6.00 to \$9.20 immediately rather than over a two-year transition period, as MAG proposes. And Centrex SLC caps should be the same as for other multiline business lines rather than using a PBX trunk equivalency approach. WorldCom at 8.

Remaining Non-Traffic Sensitive Cost Recovery. AT&T recommends that the common line component of RAS be established at a level sufficient to eliminate the CCL charge by the end of the transition to a residential SLC cap of \$6.50 on July 1, 2003. To the extent there is a CCL charge, the costs embodied therein should be recovered predominantly on originating CCL minutes.[4] Moreover, as noted above, the RAS should be available to *all* ROR carriers and ROR carriers opting for incentive regulation, irrespective of their Path A or Path B status or NECA pool participation. *See Part II below "Portability of Universal Service Support."*

Traffic Sensitive Rates. Under the MAG proposal, other NECA switched access rates are reduced to a point where the average rate per minute, known as the "composite access rate" ("CAR"), is \$0.0160 on July 1, 2003. There is broad support among the commenters for reducing traffic sensitive rates. As TCA (at 4) explains, "[t]he lower

[4] *Access Reform Order* ¶¶ 349-357. This is a change that the Commission has already adopted for the price cap LECs.

access rates envisioned by the MAG plan will greatly reduce the economically inefficient incentives for competitors to pursue high-volume users and will help ensure that all customers will benefit from competition." *See also* Qwest at 2. As California (at 14) observes, the "proposed reductions in traffic-sensitive switched access rates are advantageous in that they move access charges closer to those of non-rural carriers." *See also* Illinois at 7 (advocating that both Path A and Path B carriers reduce their traffic sensitive rates). However, as several parties explain, MAG's proposed $0.0160 rate "produces an unjustified and anti-competitive discrepancy between the . . .CALLS rate." GCI at 3. Accordingly, as Global Crossing (at 6-7) suggests, per-minute switched access rates should be reduced to the CALLS $0.0095 rate for small rural carriers given that the ROR carriers have similar scale, scope and terrain limitations. *See also* AT&T at 6-8. Indeed, as Sprint (at 5-6) points out, some ROR LECs, such as AllTel and Century, should arguably be subject to the $0.0065 CALLS per minute rate. MAG's suggestion that it proposes the same percentage reduction as CALLS disregards the fact that price cap regulation had already reduced large carriers' access rates and that CALLS is second generation incentive regulation. Sprint at 6.

These traffic sensitive rate reductions will help maintain the ability of long distance carriers to sustain nationwide averaged pricing. Wisconsin at 8. Indeed, "[c]onverting the implicit subsidies contained in the existing rates to explicit mechanisms ... will reduce the IXCs' cost of serving rural areas and will provide the proper financial incentives for existing providers to remain or new providers to enter." TCA at 5. By contrast, retaining implicit subsidies in carrier access rates is incompatible with a competitive environment and the continuing disparity between rural and non-rural carriers' access rates creates significant pressure on interexchange carriers to geographically deaverage toll rates, in a manner that conflicts with the requirements of Section 254(g) of the Act. AT&T at 7-8; GCI at 3. Also, as Illinois (at 7) points out, "[l]eaving too many different per minute charges for different carriers makes untangling the current access charge regime difficult and defeats the underlying purpose of establishing a more cohesive and less complex regulatory regime.")

Ad Hoc (at 26), while supportive of High-Cost Fund III, which would serve to move interstate access charges closer to economically rational levels, is concerned that a transfer of the non-price cap LECs' current revenue requirements to a fixed High-Cost Fund III would "freeze in perpetuity a revenue stream that, by all economic measures and indicators, should be declining over time." ROR regulation controls these LECs' revenue requirements at this time, and High-Cost Fund III is a residual. Although in the long-term Ad Hoc is correct that there should be a transition to incentive regulation with a productivity factor, the Commission should not sacrifice lowering access charges now because of the present lack of an efficient price cap proposal. AT&T at 3-4, 23.

On the other hand, ICORE (at 6) objects to MAG's proposal to reduce traffic sensitive rates and transfer LECs' residual revenue requirements to High-Cost Fund III. It states that "[t]here is no policy or legal reason for the FCC to sacrifice compensatory access rates and the protection of universal service on an altar of a ballooning and politically teetering federal subsidy-welfare system." This rhetoric is shortsighted. First, reducing access rates closer to cost is economically efficient and needed to sustain nationwide rate averaging. Second, transferring LEC revenue requirements to High-Cost Fund III protects a LEC from cream-skimming because it ensures that per-line support for high-cost areas will remain available, support which would be drained away if left implicit in access rates and a new entrant wins the LEC's high-volume customers in the lower cost areas. Third, ROR companies would obtain benefits in the retail long distance market from reduced access charges because their long distance services would need only to cover an access cost of \$0.0095 per minute instead of the much higher \$0.0394 per minute which would make it prohibitive for them to compete against a nationwide long distance carrier that recovers an average access rate that is significantly lower than \$0.0394. *Cf. CALLS Order* ¶ 55. Fourth, these subsidies must be eliminated per the Section 254(e)'s directives. *See Alenco supra.* Finally, the ROR LECs already derive a large percentage of their revenue requirements from the USF. *See* Interstate Telecom RTF Comments, filed February 26, 2001, at 3.

USF Flowback. Unlike CALLS, MAG does not include a proposal to eliminate non-price cap carriers' flowback of their USF contribution obligations to long distance carriers, and the Commission inquires whether such a provision should be required. NPRM ¶ 18. MAG (at 21) contends that LECs' existing access rate elements and line items are sufficient and an explicit means of recovering such carriers' USF contribution, and that it would be costly and burdensome for the Commission to require some other form of recovery. As AT&T (at 8) showed, the Fifth Circuit has ruled that recovery of LECs' USF contributions through carrier-paid access charges constitutes an impermissible implicit subsidy. *Texas Office of Public Utility Counsel v. FCC.*[5] WorldCom (at 11) demonstrates that a failure to remove flowback from non-price cap carriers' rates would violate Section 254(e) of the

[5] 183 F.3d 393, 425 (5th Cir.1999), *cert. denied sub nom AT&T Corp. and MCI WorldCom Corp. v. Cincinnati Bell Telephone Company*, 120 S.Ct. 2237 (June 5, 2000), as implemented by the Commission, *Federal-State Joint Board on Universal Service and Access Charge Reform*, Sixteenth Order on Reconsideration in CC Docket No. 96-45, Eighth Report and Order in CC Docket No. 96-45, Sixth Report and Order in CC Docket No. 96-262, FCC 99-290 (Oct. 8, 1999) ("Implementation Order"), *appeal pending sub nom. Comsat Corporation v. FCC,* No. 00-60044 (5th Cir.).

Act, and inclusion of NECA's USF contribution in the RAS would inflate the USF by $40 million or more annually. Accordingly, the Commission should ensure that all non-price cap carriers recover their USF obligations from their end user customers either in the form of an increment to the SLC or an additional line-item on the customer bill. Allowing non-price cap LECs to add the USF recovery factor to the SLCs would eliminate any administrative or cost burden associated with requiring them to establish a separate line-item on the end-user bill.

II. THE MAG USF PROPOSAL WOULD ALLOW FOR USF SUBSIDY GROWTH WITHOUT REQUIRED INVESTMENT IN THE NETWORK.

MAG contains a number of features that could result in significantly increased USF support for both Path A and Path B carriers. Accordingly, AT&T urges the Commission to adopt the RTF proposal as a package, which is a comprehensive USF plan, based on a consensus among varied constituents and has several cost-containment features. By contrast, MAG is a plan developed exclusively by the LECs and thus does not include some of the restraints in the RTF proposal.

Elimination of Caps on High-Cost Loop Fund and Corporate Operations Expense Limitation. Unlike RTF, under the MAG proposal, there would be unconstrained growth in the USF because of a totally uncapped high-cost loop fund and elimination of the corporate operation expense limitation. Moreover, once a study area opts for incentive regulation, its high-cost loop fund would be converted to an inflation-adjusted support per line and would no longer be based on a LEC's investment in loop facilities. This spiraling support, without network investment, simply increases LECs' profitability without any public interest benefit. In light of these facts, a number of parties maintain that the indexed cap on the

High-Cost Loop Fund should be retained to create the proper efficiency incentives and, if anything, the Commission should look for ways to reduce the cap. Ad Hoc at iii, 16; Global Crossing at 11-12; Illinois at 11; NASUCA at 21-22; NYDPS at 1; Sprint at 8; WorldCom at 5. On the other hand, some parties, including Wisconsin (at 6), support elimination of all caps. RORC at 6; Small Rural LECs at 4; TCA at 6. The RTF proposal is the proper compromise solution to these opposing positions.

Portability of Universal Service Support. Under the MAG proposal, the RAS (rate averaging support) is restricted to those Path A LECs that elect to participate in the NECA pool.[6] As numerous parties confirmed in response to the NPRM (¶ 17) inquiry, restricting the RAS is *inappropriate*. Alaska at 6; AT&T at 6, 9-10; California at 3; CUSC at 7, 10-12; FWA at 5; GVNW at 4; ICORE at 17; Innovative at 3-4. The RAS (or High-Cost Fund III under RTF) should be available to *all* non-price cap LECs, both to keep their traffic sensitive rates low and to allow new entrants to obtain the same subsidy amount as the incumbent. If as MAG posits, the RAS permits long distance carriers to maintain geographically averaged toll rates, then it should apply to both pooling and non-pooling LECs. As GCI (at 3-4) explains, RAS should apply to all ROR carriers otherwise implicit subsidies will remain in rates, putting pressure on LECs that leave the pool to charge higher

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[6] MAG classifies ROR LECs into two categories. Path A companies could elect incentive regulation for individual study areas at the start of the transition but would not be required to convert all study areas to incentive regulation until the end of the 5-year transition period. Under Path B, the LEC would remain under ROR regulation with the option to move to Path A at any time during the 5-year transition. Both Path A and Path B companies would have the option of participating on a study area basis in the NECA common line and/or traffic sensitive pool, which would be combined. Depending on the form of regulation, pooling LECs would recover interstate access settlements from the pool through use of average schedules, on a cost basis or through incentive regulation based on revenue per line.

traffic sensitive rates. Moreover, absent portability of the subsidy, competitive entry into rural areas will occur only for high-volume customers who are in the lower cost areas served by these LECs. *See* MAG at 5 (competition "focuses on lower cost, high-volume business customers.") As such, broader competitive entry will be thwarted, thereby limiting consumer choice. FWA (at 8, 10-12) erroneously suggests that wireless carriers should be denied the same level of support as the incumbent because of allegedly lower costs. Even if wireless carriers had lower costs, a failure to make the entire subsidy portable would violate competitive neutrality.

RAS and Size of USF. In response to the NPRM's (¶ 18) inquiry as to what extent is RAS likely to increase the size of the USF and how will RAS support levels increase over time, AT&T (at 10) had estimated that if all ROR carriers receive the RAS, which recovers the difference between LEC revenues derived from rates (SLCs and traffic sensitive rates), long term support and local switching support, the size of the USF would increase by approximately $610 million annually, if SLC caps were increased to their maximum CALLS values and the traffic sensitive access rate were set at $0.0095. This is roughly equivalent to the magnitude of the USF increase for price cap LECs under CALLS and thus appears to be reasonable for the ROR LECs.

As California (at 16) observes, because RAS grows by lines plus inflation, it "automatically increase the size of the [USF] each year with no consideration of whether the growing amount of universal service support is needed." Indeed, as discussed in Part III below (*see "Revenue Growth Should Be Constrained Under Incentive Regulation"*), the problem with MAG is that, even under incentive regulation, it fails to sufficiently constrain LEC revenues, resulting in an ever-increasing RAS based solely on line growth plus inflation.

AT&T at 11, 15-17; Qwest at 2-4; Wisconsin at 10 ("a USF support incentive regulation plan that includes an inflation increase and does not include a productivity factor decrease will excessively compensate utilities and burden the universal service fund.") By contrast, under the RTF proposal, High-Cost Fund III would be adjusted annually based on ROR carriers' annual filings to determine whether a LEC needs more or less support to maintain its authorized rate-of-return, while charging a $0.0095 traffic sensitive rate. AT&T at 11. Accordingly, the Commission should adopt the RTF proposal as the appropriate compromise mechanism.

Contrary to MAG's proposal, RAS should *not* be available to support special access services. AT&T at 11; California at 14-15; Sprint at 8; WorldCom at 14-15. USF support for special access would be an unprecedented and unwarranted increase in the size of the fund, and inconsistent with the scope of the "core" services that the Commission has defined as eligible to receive universal service support.[7]

Several parties point out that forward-looking economic cost ("FLEC") should be used to size the USF. Ad Hoc at 3-10; California at 2-3, 8. Certainly, in the long-term, FLEC should be used to size the USF. However, the FLEC model was found to be inappropriate for rural carriers at this time. Accordingly, as WorldCom (at 13) advocates, an embedded cost mechanism should be permitted for an interim period not exceeding 5 years with clarification by the Commission that it is not reconsidering FLEC. WorldCom (at 14-15) also expresses some concern that the RAS would inflate the USF simply because it would result in diminished oversight of NECA's projected revenue requirement. To the contrary,

[7] *Federal-State Joint Board on Universal Service*, First Report and Order, 12 FCC Rcd 8776, 8807-8825 (1997).

there is no reason why the creation of High-Cost Fund III should diminish oversight of NECA. *See* AT&T RTF Comments, filed February 26, 2001, at Appendix A.

Advanced Services. The NPRM (¶ 21) seeks comment on the validity of MAG's premise that USF funding caps and regulatory uncertainty have diminished non-price cap carriers' incentives to invest in new technologies and whether MAG requires the use of USF funding to support advanced services. First, MAG's premise is incorrect. As AT&T (at 11-13) showed, there has been tremendous growth in advanced service in rural company areas.[8] Thus, the National Rural Telecommunications Association, the National Telephone Cooperative Association, and the Organization for the Promotion and Advancement of Small Telecommunications Companies demonstrated in the Commission's Section 706 proceedings that their members are actively deploying advanced telecommunications capability to rural America in a reasonable and timely manner.[9]

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[8] *See Communications Daily* (November 10, 1999) (National Telephone Cooperative Association study shows that small rural telcos . . . have infrastructure in place to offer advanced services to those areas . . . [and that] "[t]he so-called 'digital divide' is greatly exaggerated with respect to areas served by small telephone companies"); *see also* Comments of AT&T Corp., filed March 20, 2000, in *Inquiry Concerning Deployment of Advanced Telecommunications Capability to All Americans in a Reasonable And Timely Fashion, and Possible Steps To Accelerate Such Deployment Pursuant To Section 706 of the Telecommunications Act of 1996*, CC Docket No. 98-146, at 19-21, 28-30; *id.* Reply Comments, filed April 4, 2000, at 4-6. *See also* Economics and Technology, Inc., *Bringing Broadband to Rural America: Investment and Innovation in the Wake of the Telecom Act* at 43 (Sept. 1999), filed with the Commission in CC Docket 98-147 on September 10, 1999. *See also* John Borland, *Firms Target Rural Communities for Broadband*, CNET News (Feb. 4, 2000) <http://news.cnet.com/news/0-1004-200-1541543.html> (discussing strategies of New Edge Networks, Jato Communications, DSL.Net, and OneMain.com to bring high-speed access to small towns).

[9] *See* Comments, in CC Docket No. 98-146, filed March 20, 2000, by NRTA at 2, 7-9; NTCA at 5-6; OPASTCO at 5-6.

Second, MAG does *not* require use of USF funding to support infrastructure capable of providing advanced services but simply permits additional USF funding based on line growth plus inflation. Thus, MAG in no way ensures the deployment of infrastructure needed to support advanced services. AT&T at 13; Illinois at 11.

In all events, as Missouri (at 5) points out, "household income is, statistically speaking, the real cause for the 'digital divide'"), not the lack of high-cost support. Although MAG does not suggest that there should be direct support for advanced services at this time (just for plant capable of supporting advanced services), as several parties correctly note, the issue of whether advanced services should receive USF support should be addressed in a broader industry-wide proceeding. Ad Hoc at 27; NYDPS 1; Qwest at 6-7.

III. THE MAG PROPOSAL FAILS TO INCORPORATE THE PROPER INCENTIVES FOR EFFICIENCY AND WOULD ALLOW LECS OPTING FOR INCENTIVE REGULATION GREATER REVENUE RECOVERY THAN UNDER ROR REGULATION.

The MAG proposal grants the non-price cap LECs far too much flexibility and would not provide the carriers opting for incentive regulation the proper efficiency incentives. In the NPRM (¶ 16), the Commission seeks comment on the potential effects of the MAG plan on competition and the universal service goals of the 1996 Act. AT&T and others believe that MAG is an overly generous plan without sufficient efficiency incentives for the LECs that would strain the consumer price tag. AT&T at 13-17; Qwest at 2-4; Sprint at 8-9; Texas at 4; WorldCom at 2. In the next phase of this proceeding, the Commission should proceed to develop a properly-constructed incentive plan that would ensure that revenue growth tracks underlying cost growth. The commenters' positions on specific aspects of the MAG incentive regulation proposal are discussed below.

Two-Tier Approach. Like AT&T, a number of parties believe that MAG gives unwarranted discretion to carriers to elect Path A or B. CUSC at 11; Sprint at 7. They criticize that a five-year transition would allow LECs to buy excessive equipment knowing that recovery would be guaranteed if the LEC selects Path A. Florida at 6. Accordingly, in lieu of the Path A/ Path B approach proposed by MAG, once the Commission adopts a well-designed incentive plan, it should adopt a two-tiered approach that would make incentive regulation *mandatory* for the largest ROR LECs.[10] Large non-price cap carriers have the necessary scope to benefit from increased efficiency incentives under incentive (price cap) regulation thereby increasing their profitability, which, under a well-structured plan, would translate into rate reductions that would promote consumer welfare. It would defeat the purpose of incentive regulation if these carriers were afforded the discretion to gold-plate their networks and raise rates before electing price cap regulation. Indeed, given the "lumpy" investments made by some ROR carriers (*see, e.g.*, Interstate Telcom at 7-9), it is particularly important that they should not be permitted when to choose when to convert to incentive regulation, because LECs have an incentive to convert when their costs are at a cyclical peak so as to obtain high initial rates under price caps. This suggests that the FCC will need to scrutinize initial price cap revenue per line levels to ensure that they have not been inflated due to inordinately high costs in a particular year. Under the two-tiered approach that AT&T (at 13-14) suggests, only smaller carriers should have the *option* of electing incentive regulation on a voluntary basis. This would accommodate the concerns of smaller ROR LECs that "one size fits all" does not work and that incentive regulation may not be viable for the

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[10] *See* n.6 *supra.*

smallest carriers. ALECA at 2; ITTA at 2; Innovative at 6; RORC at 4; TANE at 2; Townes at 2, 4; Western Alliance at 7-8.

All or Nothing. Contrary to MAG's assertion (at 28) that the all-or-nothing price cap rule has been made obsolete by the plan, for both mandatory companies and those smaller companies that could opt for price cap regulation, the Commission should require *all* study areas to convert to price cap regulation at the same time. As WorldCom (at 5) and Global Crossing (at 13) explain, absent this requirement (which is not a feature of the MAG plan), carriers with mixed price cap/ incentive regulation could engage in cost-shifting and gaming so as to maximize profitability. AT&T at 14. Moreover, MAG's contention (at 28) that current accounting and reporting requirements are sufficient to guard against cost-shifting is incorrect. As WorldCom (at 5) explains, such cost shifting between ROR and price cap affiliates would be particularly difficult to detect because of reduced accounting requirements for small LECs.

No Pooling Under Incentive Regulation. As AT&T (at 15) showed, contrary to MAG's proposal, pooling by companies subject to incentive regulation should not be permitted. As the Commission explained, the "relationship between pooling and price cap regulation is fundamental to the rules defining LEC eligibility for price cap regulation. We have repeatedly emphasized . . . that price cap regulation will increase carriers' incentives to achieve heightened efficiency, which in turn will lead to lower rates. Participation in pools, by its nature, entails risk-sharing, and thus a weakening of incentives to operate efficiently."[11]

[11] *Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, 5 FCC Rcd 6786, 6819 (1990) ("LEC Price Cap Order"). Accordingly, Sections 61.41(a)(3) and 69.3(i)(4) of the Commission's rules bar price cap companies from participation in the NECA CL and TS pools.

Revenue Growth Should Be Constrained Under Incentive Regulation. Under the MAG proposal, the common line and traffic sensitive revenues of LECs opting for Path A incentive regulation, as well as the USF subsidy that such carriers would receive in the form of high-cost loop support, would increase based on growth in lines plus inflation.

In the NPRM (¶ 20), the Commission seeks comment on what effect the MAG plan is likely to have on LEC revenues and whether an inflation factor equal to the Gross Domestic Product Price Index ("GDP-PI") accurately reflects changes in cost per line, or whether an X-factor or consumer productivity dividend should be included in the revenue per line formula. Numerous commenters confirm that, consistent with its price cap objectives, the Commission should adopt a formula that reasonably reflects the trend in LECs' costs to ensure "that ongoing gains by the LECs in reducing unit costs are passed through to consumers."[12] Ad Hoc at 26; AT&T at 15-17; California at 1; Global Crossing at 7-9; Illinois at 7-9; WorldCom at 4.

MAG (at 9), however, claims that access revenues plus RAS are estimated to be about the same as access revenues under rate-of-return regulation throughout the plan's proposed five-year transition period. MAG (at 25) further asserts that X-factors used in price cap regulation and in CALLS do not "directly limit the revenues per line of any carrier" and that applying an X-factor the revenue per line could so reduce revenue per line as to make incentive regulation unattractive for most LECs. *See also* GVNW at 6; ICORE at 8-9; Plains at 8; RORC at 5; TANE at 3; Townes at 3; Western Alliance at 12-13 (rural LECs do not have size or operating scale to accommodate a productivity factor). Contrary to these assertions, as

[12] Fourth FNPRM in CC Docket 94-1, FCC 95-406, ¶ 16, released September 27, 1995.

AT&T demonstrated in Appendix A of its comments, examination of the TRP data filed by NECA for its common line and traffic sensitive pools demonstrates that an X-factor is clearly warranted for the ROR companies that convert to incentive regulation to reflect productivity gains primarily in switching and transport. Specifically, AT&T showed that, on a historical basis, access revenues plus RAS would have significantly exceeded ROR LECs' revenue requirements and there is no reason to believe that this pattern would not continue in the future. Given MAG's revenue per line approach, AT&T had posited an X-factor of 3.3%. WorldCom (at 4-5) correctly points out, however, that if the Commission adopts traditional price cap regulation for the ROR LECs, they should be able to operate successfully under a 5.3 or 6.5 X-factor, as the rural GTE, Frontier and Sprint LECs had done. *See also* Illinois at 9 ("It should be incumbent upon the MAG proponents to demonstrate the necessity for a significantly lower X factor than the one designed for the CALLS carriers.") Accordingly, the FCC should initiate a further NPRM to establish an X-factor and consumer productivity dividend, as well as address other price cap issues.

Low-End Adjustment. One of the problems with the MAG proposal is that LECs get increased profits through cost reductions and a guaranteed return through the low-end adjustment. Alaska at 3-5; ASCENT at 4-5; California at 1. There should be no low-end adjustment ("LEA") unless the incentive plan also contains a provision for sharing earnings above a certain level with ratepayers, which the MAG plan does not. AT&T at 17; CUSC at 16. Moreover, the proposed 10.25% and 10.75% thresholds for a LEA are overly generous because they are well above the LECs' current cost of capital. AT&T at 17; California at 3, 24. As under the current price cap plan, a single LEA threshold should apply for all carriers. AT&T at 17.

Other Needed Access Reforms. As AT&T (at 17-18) showed, the Commission should implement varying access reforms for all non-price cap LECs. First, it should modify Section 69.307 of its rules to ensure that costs supporting nonregulated billing and collection functions are no longer recovered via access rates but are instead assigned to the billing and collection category.[13] Second, local switch line port costs should be transferred to the common line category and recovered from end users (or the USF) and trunk port costs should be recovered from IXCs on a flat-rate basis.[14] Each of these changes, which the Commission has already adopted for the price cap LECs, is necessary to ensure that costs are recovered in a cost-causative manner.

IV. THE COMMISSION SHOULD NOT ADOPT VARIOUS OTHER ASPECTS OF THE MAG PROPOSAL RELATED TO MERGERS AND ACQUISITIONS, JURISDICTIONAL SEPARATIONS, PRICING FLEXIBILITY AND IXC REGULATION.

Mergers and Acquisitions. The NPRM (¶ 22) asks whether the "all or nothing" rule in connection with mergers and acquisitions between companies under price cap and ROR regulation should be eliminated, as MAG proposes. It also inquires whether MAG's proposal to eliminate the freeze of study areas for non-price cap LECs is warranted and whether MAG adequately addresses gaming concerns if Section 54.305 were eliminated. As ASCENT (at 6) shows, these rules should be retained as they are "all designed to thwart the strategic manipulation of costs and universal service support." *See also* Ad Hoc at 18; AT&T

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[13] The Commission adopted this modification for price cap LECs several years ago. *See Access Charge Reform,* CC Docket No. 96-262, Third Report and Order, FCC 97-401, ¶¶ 33-35, 43-49, released November 26, 1997.

[14] *Access Reform Order* ¶¶ 123-35.

at 18-19; California at 25 ("Elimination of those rules would encourage price cap LECs to sell their more rural exchanges at a premium...."); Florida at 5. Of course, the MAG supporters, such as Innovative (at 13) and RORC (at 5-6), would like to see each of these rules eliminated so as to maximize the support they receive for transferred exchanges. The correct solution to these conflicting positions is the RTF plan which would not eliminate any of these rules but would allow for a modicum of "safety valve" support for post-acquisition investment by the LEC. CUSC at 19.

As WorldCom (at 6) shows, the "all or nothing rule" should be retained; otherwise the acquired carriers' customers would be deprived of the efficiency benefits of price cap regulation, and it could be construed to allow PRTC to remain a ROR carrier. But "there would be no justification for allowing the notoriously inefficient PRTC to remain a non-price cap carrier .... now that [it] is an affiliate of Verizon, and can benefit from the economies of scale and scope inherent in being a part of the nation's largest local exchange carrier..."[15] In fact, the Commission should "ensure that unnecessary support flows – such as $89 million [LTS] for the largest local exchange carrier in the nation – are discontinued." WorldCom at 19.

Separation Freeze. The MAG plan proposes a freeze of all Part 36 allocation factors for ROR companies. As AT&T (at 19) has demonstrated, such a freeze would embed into the separations process various pre-existing flaws that already result in over-assignment of costs to the interstate jurisdiction. Moreover, such a freeze would prevent additional costs

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[15] *See* AT&T Opposition to PRTC Supplement to Petition for Waiver, filed March 9, 2001, in *Puerto Rico Telephone Company Petition for Waiver of Section 61.41 or Section 54.303(a) of the Commission's Rules, CCB/CPD No. 99-36.*

from being assigned to the intrastate jurisdiction as a result of rapid growth of Internet traffic that is treated as intrastate for separations purposes.[16]

Pricing Flexibility. MAG proposes that new access services be introduced at prevailing market rates. NPRM ¶ 14. However, as Alaska (at 3) and California (at 15) explain, in the absence of competition, the term "prevailing market rates" means "monopoly pricing." Accordingly, LECs should continue to introduce new services with cost support, and any future pricing flexibility should be linked to a competitive showing. AT&T at 19; CUSC at 16.

Geographic Rate Averaging and Rate Integration. MAG (at 30-31) proposes that IXCs be required to pass through to consumers any savings realized from lower rates as a result of implementation of the MAG plan and to offer consumers in rural and urban areas the same optional calling plans. It further proposes to prohibit IXCs from imposing minimum monthly charges on residential consumers. NPRM ¶¶ 13, 23. As numerous carriers demonstrate, these requirements are unnecessary. AT&T at 19-20; CUSC at 21; Global Crossing at 10; Qwest at 7-8; Sprint at 10-11; WorldCom at 20. Given that the long distance marketplace is characterized by intense rivalry, the Commission has properly elected to rely on market forces and the complaint process to achieve the objectives of the Act.

[16] *See* AT&T Comments on Joint Board Recommended Decision on Jurisdictional Separations, filed September 25, 2000, in *Jurisdictional Separations Reform and Referral to the Federal-State Joint Board*, CC Docket No. 80-286, at 2 & *im passim.*

CONCLUSION

For the reasons stated above and in AT&T's Comments, by July 1, 2001, the Commission should adopt and implement a modified version of the MAG access rate level changes, as described in Part I, in conjunction with the universal service reforms proposed by the RTF, including the establishment of a High-Cost Fund III. Before adopting these changes, it should eliminate the competitive imbalance caused by the USF lag. It should consider MAG's incentive plan, including productivity and other issues, in a further phase of this proceeding.

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March 12, 2001

CERTIFICATE OF SERVICE

I, Judy Sello, do hereby certify that on this 12th day of March, 2001, a copy of the foregoing "AT&T Reply Comments on MAG NPRM" was served by U.S. first class mail, postage prepaid, on the parties named on the attached Service List.

/s/ Judy Sello

Judy Sello

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