

BEFORE THE
Federal Communications Commission
WASHINGTON, D.C.

In the Matter of)
)
Implementation of the Local Competition) CC Docket No. 96-98
Provisions of the Telecommunications Act of)
1996)

COMMENTS OF TIME WARNER TELECOM

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Time Warner Telecom ("TWTC"), by its attorneys, hereby submits these comments in response to the Public Notice dated January 24, 2001¹ in the above-captioned proceeding.

INTRODUCTION AND SUMMARY

The Commission's review of the limitations placed on the availability of UNEs to provide access comes at a critical time for competition. Hundreds of firms entered the market following the passage of the Telecommunications Act of 1996 to provide competitive local exchange, exchange access, and special access services. Many of those firms have now failed or are perilously close to failing. In other proceedings, the Commission threatens to hasten many of these firms' demise by mandating reductions in the exchange rate for ISP-bound traffic and CLEC switched access charges in the near future. The apparent concern in both of these areas is

¹ See *Comments Sought on the Use of Unbundled Network Elements to Provide Exchange Access Service*, Public Notice, DA 01-169 (rel. Jan. 24, 2001) ("Notice").

that CLECs have been able to take advantage of a market failure caused by a third-party pays situation.

But there is at least one class of services that CLECs are successfully providing over their own facilities where it cannot be argued that they are exploiting a market failure: special access. Firms such as TWTC have made some progress in gaining a share of this market by underpricing the ILEC and by providing superior service quality. If true competitive alternatives to the ILECs are ever going to develop, this is precisely the market in which the Commission should *not* intervene to lower prices artificially.

The Commission should instead establish as a permanent rule the restriction on the availability of UNEs to provide access set forth in the *Supplemental Order* in this proceeding. Such a rule is feasible as a practical matter, since special access constitutes a distinct and discrete product market. Moreover, a permanent rule would avoid the potentially very harmful effect that TELRIC-based prices for special access could have on facilities-based competition. It would allow facilities-based competition to continue to develop as new entrants achieve scale economies. This process will in turn ensure more efficient (and of course lower) prices over time and the further reduction of regulation. In contrast, regulatory prescription down to TELRIC-based prices would likely lead to less facilities-based competition, less efficient pricing over time, and the continued need for regulation (since special access purchasers would continue to purchase service from ILECs). There is no better example of a choice between the long-term benefits of facilities-based competition versus the purported short term benefits (and long term

costs) of resale competition. TWTC submits that the case for facilities-based competition in this instance is irrefutable.²

DISCUSSION

In the Public Notice, the Commission seeks further comment on whether it should require ILECs to provide UNEs to requesting carriers that seek to use the UNEs solely to provide interstate access. The Commission is trying to determine the extent to which the temporary constraint on the use of UNEs extended and clarified in the *Supplemental Order*³ should be retained. Under the constraint, a requesting carrier must provide a “significant amount of local exchange service” to a customer in order to obtain loop-transport combinations for the purpose of serving the customer. As explained below, the Commission should retain the temporary constraint as a permanent limitation on the availability of UNEs to provide access.

As an initial matter, there should be little question after the comments filed in response to the *Fourth Further Notice of Proposed Rulemaking*⁴ that the Commission has the authority to limit on a permanent (not just interim) basis requesting carriers’ ability to use loop-transport combinations solely for access. As was explained in detail in those comments, even where

² While these comments focus only on the questions of whether special access constitutes a distinct product market and the effect on competition of UNE pricing, TWTC fully supports the ALTS comments in this proceeding, which focus on the measures required to ensure the availability of loop-transport combinations used to provide significant amounts of local exchange service.

³ See *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, 15 FCC Rcd 9587 (2000).

⁴ See *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, 15 FCC Rcd 3696 (1999).

requesting carriers technically meet the “impair” standard for a particular point-to-point route, the Commission has the authority to preserve and advance the progress of facilities-based special access competition by restricting the use of UNEs to provide special access service.⁵ This policy is consistent with the Commission’s long-standing and consistent policy of relying on facilities-based entry rather than regulatory prescription as the means of ensuring enhanced efficiency and lower prices in the access market generally and the special access market in particular. This policy approach is feasible as a practical matter because special access constitutes a distinct and discrete product market. This policy is also essential if the Commission is going to give firms like TWTC the incentive to continue entering new markets to provide special access and to expand the scope of such offerings in markets already entered.

First, placing limitations on the use of loop-transport combinations for the provision of special access is feasible, because special access service (along with private line service) constitutes a distinct and separate product market from switched access service. The Commission can therefore restrict the use of UNEs to provide special access without significantly affecting requesting carriers’ ability to provide switched services.

The Commission has previously defined a product market as a service “for which there are no close demand substitutes.”⁶ In order to determine relevant product markets, “the

⁵ See e.g., Comments of TWTC at 10-18; Comments of SBC at 12-30.

⁶ *Applications of NYNEX Corp. and Bell Atlantic Corp. for Consent to Transfer Control*, 12 FCC Rcd 19985, ¶ 50 (1997) (citation omitted) (“*BA/NYNEX Order*”); *Application of WorldCom, Inc. and MCI Communications Corp. for Transfer of Control*, 13 FCC Rcd 18025, ¶ 164 (1998) (“*WC/MCI Order*”). Although at one point the Commission considered supply substitutability when defining product markets, it has since concluded that, consistent with the

Commission must consider whether, if, in the absence of regulation, all carriers raised the price of a particular service or group of services, customers would be able to switch to substitute services offered at a lower price.” *BA/NYNEX Order* ¶ 50; *see also WC/MCI Order* ¶ 164 (Commission looks to whether “each of the[] services is a distinct product lacking good substitutes”). This approach is consistent with the Department of Justice’s *Merger Guidelines*, which provide that “[m]arket definition focuses solely on demand substitution factors -- *i.e.*, possible consumer responses.” *DOJ Merger Guidelines* § 1 (1992). As discussed below, most customers cannot easily substitute special for switched access. As a result of these and other differences, the Commission has historically treated special and switched access as two separate and distinct product markets. From both an economic and regulatory viewpoint, special access is not, and has never been treated as, a “close demand substitute” for switched access.

Product Substitutability. While there is some substitution between special and switched access users due to differences in pricing,⁷ this substitution is minimal and does not overcome the fact that special access is a poor substitute for switched access. In 1993, the Federal Trade Commission submitted a study in the Commission’s *Expanded Interconnection* proceeding

1992 *Merger Guidelines*, “market definitions should be based solely on demand substitutability.” *See Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC’s Local Exchange Area*, 12 FCC Rcd 15756, ¶ 27 (1997).

⁷ Special access is priced on a flat monthly rate based on the capacity of the line, while switched access is priced on a per-minute actual usage basis. Thus, whether a customer subscribes to special rather than switched access depends on the point at which, for a given calling volume, special access is priced lower than switched access. It should be noted that, in the past, regulatory distortions in the prices of special and switched access have substantially skewed the substitutability of these two services. High switched access prices caused many purchasers to substitute special for switched access where cost-based rates probably would not have otherwise warranted substitution. But as prices for switched access have dropped over the past decade, these distortions have become less significant.

which estimated that “the elasticity of substitution in demand between switched and special access is -0.34 for AT&T and -0.21 for the Other Common Carriers.”⁸ These estimates “imply that a price increase in switched access relative to special access of 10% would induce a 3.4% decrease in the proportion of switched to special access demanded by AT&T and a 2.1% decrease for [Other Common Carriers].” *Id.* Extrapolating from this analysis and assuming the elasticity remains the same today, even if carriers were to increase switched access prices 50% relative to special access that increase would only induce a 17% decrease in the relative proportion of switched to special access demanded by AT&T and a 10.5% decrease for other carriers. It follows that for the overwhelming majority of purchasers, special and switched access are not close demand substitutes.

Demand Patterns. With regard to local exchange and exchange access service, the Commission in the past has identified two types of consumers that have similar demand patterns and thus form separate product markets: the mass market and the larger business market. *WC/MCI Order* ¶ 164; *BA/NYNEX* ¶¶ 51, 53. Each of these groups exhibits distinct buying patterns, both in terms of the types of services they desire as well as the volumes. *WC/MCI Order* ¶ 26, 164. Purchasers of special access, which are IXCs and large businesses, typically demand different types of telecommunications services (*e.g.*, ISDN or extensive voice mail

⁸ *Expanded Interconnection with Local Telephone Company Facilities*, 1993 FCC LEXIS 1173, at *33 (March 5, 1993). As the FTC notes, the “elasticity of substitution in demand” should not be confused with “cross-elasticity in demand.” *Id.* at n.45. While cross-elasticity measures the change in demand for commodity X when the price of commodity Y changes, elasticity of substitution in demand “measures the percentage change in the ratio of the quantity demanded of two goods due to a percentage change in the ratio of their prices.” *Id.*

systems) that are not desired by residential or small business end users. *Id.* ¶ 164 & n.453. Also, one of the key reasons that large businesses purchase special access is that they have sufficient traffic volume to make special access cost-effective. This is not the case with purchasers of switched access, which are usually residential or small business customers. *Access Charge Reform*, 14 FCC Rcd 14221, ¶ 142 (1999) (“*Access Charge Fifth Report*”). Also, firms require different assets and capabilities to successfully serve these two groups. For example, switch-based providers can be expected in the long run to seek to spread the sunk costs of their switch over as broad a base of customers as possible, and thus to target customers with smaller and smaller volumes of traffic. *Id.* ¶ 120. Those customers are served primarily through mass marketing techniques such as advertising and telemarketing. *Id.* In comparison, special access providers typically target IXCs and large business customers. *Id.* ¶ 142. These customers are not only marketed to directly, but they are often served under individually negotiated contracts. *Id.* ¶ 120; *BA/NYNEX* ¶ 53.

Historical Treatment. Not surprisingly, the Commission has also historically treated special access differently from switched access. Under price cap regulation, the Commission separated LEC access services into four categories, or “baskets.”⁹ Each basket has a separate

⁹ *Price Cap Performance Review for Local Exchange Carriers*, 11 FCC Rcd 858, ¶ 11 (1995) (“*Price Cap Second FNPRM*”). Indeed, in that same *Further Notice of Proposed Rulemaking*, the Commission sought comment on the propriety of defining separate product markets based on existing definitions of current service categories within each access service “basket” -- which would have definitively placed special and switched access into separate product markets. *Id.* ¶ 118. That record was later refreshed and ultimately led to the Commission’s *Access Charge Fifth Report*, which implicitly acknowledges that special and switched access constitute separate product markets requiring different pricing flexibility triggers.

“price cap index” (“PCI”), which indicates the maximum level that LECs can charge for the services in the basket. *Price Cap Second FNPRM* ¶ 10. LECs can raise or lower costs for certain subcategories in the basket, as long as they do not exceed the PCI. *Id.* ¶ 11. In order to guard against cross-subsidization of services, “the price cap system places services with high cross-elasticities of demand (competing services) in the same baskets, while separating services without high cross-elasticities of demand.” *Id.* ¶ 19. A high (positive) cross-elasticity indicates that two commodities are substitutes. *Id.* ¶ 19 & n.33. Thus, the fact that the Commission placed special access and switched access into different categories confirms that these two services are not close substitutes and thus constitute separate markets. *See also Policy & Rules Concerning Rates for Dominant Carriers*, 5 FCC Rcd 6786, ¶ 219 (1990) (creating basket subcategories based on the type of service, technology, customer base, and demand trends).

Moreover, the Commission has indicated that the level of competition differs between baskets as well. In 1994, the Commission reassigned transport from the traffic-sensitive basket and combined it with special access to form a new “trunking” basket. *See Transport Rate Structure and Pricing*, 9 FCC Rcd 615, 622 (1994). This reclassification was based on the fact that switching and other traffic sensitive services were subject to less competition. *Id.*; *see also Access Charge Reform*, 11 FCC Rcd 21354, ¶ 217 (1996) (seeking comment on consolidating the trunking and traffic-sensitive baskets, but expressing concern that to do so prematurely, when the two baskets are subject to different levels of competition, will enable the LEC to price anticompetitively); *CALLS Order* ¶ 172 (creating a separate basket for special access based upon the concern that LECs would fund reductions in special access rates by raising the rates for

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switched transport). Similarly, although Part 69 establishes specific access elements and a mandatory rate structure for each element for switched access, it does not set forth specific rate elements for special access. *See Access Charge Reform*, 11 FCC Rcd 21354, 21367 (1996); *MTS and WATS Market Structure*, 93 FCC 2d 241, 314-15 (1983).

In sum, the price, demand patterns, and regulatory treatment of special and switched access services confirm that special access constitutes a distinct product market. It is therefore entirely feasible for the Commission to apply a use restriction solely to special access.

Second, restricting requesting carriers' ability to arbitrage special access rates by ordering loop-transport UNE combinations or "flipping" existing special access circuits is essential to assure the growth of facilities-based competition in the special access market. The Commission has repeatedly emphasized the benefits of relying on facilities-based competition rather than regulatory prescription. With respect specifically to special access, the Commission has found that "market forces, as opposed to regulation, are more likely to compel LECs to establish efficient prices."¹⁰

Lowering prices to TELRIC could very well diminish or even eliminate the incentive for entrants to enter or expand entry in the special access market. While there can be no question that the most efficient price for a good or service is one that is equal to marginal cost (including a reasonable profit), the more important question for the purposes of this proceeding is how to achieve such efficient price signals in the access market. If setting prices based on TELRIC

¹⁰ *See Access Charge Reform*, 14 FCC Rcd 14221, ¶ 26 (1999).

substantially reduces the likelihood for entry or expansion of entry in a market in which facilities-based competition has demonstrably developed, then policy makers should avoid setting prices at TELRIC.

To understand how TELRIC could prevent entry and distort market outcomes, it is important to review the basic considerations of dominant firms (in this case the ILECs) in setting price. As a leading economist in the field of industrial organization has described it, a dominant firm will estimate first “[h]ow high a market price for industry output it can establish without attracting entry – that is, the level of the maximum entry-forestalling price [sometimes called the “limit price”],” and second “[w]hether it . . . can make greater long-run profits by (1) charging a limit price that excludes entry, and keeping all industry profit for itself perpetually, or (2) setting a higher price that will attract some entrants into the industry, and sharing total industry profit thereafter with additional firms.”¹¹ Thus, if the dominant firm “expects higher long-run profits from a limit-price policy that excludes entry, it will presumably pursue such a policy and set price at a maximum entry-forestalling level. If it does not, it will set a higher price and attract entry.” *Id.* at 272-273.

Whether a dominant firm benefits from deterring or allowing entry (and if so, how much entry) can be determined by considering a number of factors. Most fundamentally, “the lower the limit price, the greater is the probability that a higher price will be charged and new entry thus attracted.” *Id.* at 273. In addition, the dominant firm will consider (1) “how much entry (or

¹¹ Joe S. Bain, *Industrial Organization* 272 (2d ed. 1973).

how many entrants) would be attracted by an entry-inducing price policy, and thus how much of a share of the market [it] would lose to new entrants,” (2) “how much (if at all) competition in the industry would increase as the result of induced entry, and thus how much (if at all) market price in the industry would decline as the result of entry,” and (3) “how long would be the ‘lag period’ between the time that [the dominant firm sets] an entry-inducing price and when entrants become established as competitors – a period during which [the dominant firm] could reap the extra profits of an entry-inducing price without having to share them with the entrants [or expanded entrants].” *Id.*

The problem with setting prices at TELRIC is that such low prices (significantly below current prices notwithstanding the presence of widespread entry)¹² could well push the incumbent’s price near or below the limit, entry-forestalling price. This would limit or eliminate the incentive for firms such as TWTC to enter new markets or expand entry in markets they currently serve. Absent the imposition of TELRIC-based pricing, it is entirely possible that, based on the factors listed above, ILECs would choose to set prices at entry-inducing levels. It is obviously impossible to predict with precision the amount of entry that ILECs would allow (and in any event, the ILECs would not have perfect information and could well mistakenly set prices either too high or too low to achieve their intended level of entry). Nevertheless, given the amount of entry thus far into the special access and dedicated transport markets, it seems likely

¹² SBC estimates that TELRIC would be approximately 50 percent below current special access prices. *See* Comments, CC Docket No. 96-98 (Jan. 19, 2000) at 14.

that in at least the more densely populated areas, the entry barriers to providing these services are only moderately high. In such cases, it can generally be expected that dominant firms will set prices high enough to induce entry. *See id.* at 275. If so, entry can be expected eventually to result in a much less concentrated market structure and prices will be set closer and closer to cost.

Indeed, the market appears to be well on its way in at least the urban areas to becoming characterized by pluralistic supply. USTA attempted to document the development of special access competition in the so-called Special Access Fact Report attached to its comments filed in response to the *Fourth Further Notice of Proposed Rulemaking* in this proceeding.¹³ While TWTC does not agree with every aspect of the analysis, the Special Access Fact Report does include information that illustrates the rate of growth in the provision of special access services. For example, the Report asserts that CLECs have now claimed about 30 percent of the market for special access/private line service, measured by total revenues. *See* Special Access Fact Report at 6. While this estimate, assuming it is accurate, by no means shows that CLEC special access/private line service is available for every particular point-to-point route (this is especially true for channel terminations), it does show that CLEC entry in this part of the market has been very significant in terms of revenues. Furthermore, the Report asserts that “almost 50 CLECs generate 10 percent or more of their revenues from special access/private line services” as of a

¹³ *See* Peter W. Huber & Evan T. Leo, Special Access Fact Report, Submitted by USTA in CC Docket No. 96-98 (Jan. 19, 2000).

year ago. *Id.* at 5. Thus, the special access market appears to be characterized by generally successful (though of course not uniformly so) and widespread entry. There is no reason to believe that this trend will slow in the future, absent major changes in the marketplace (such as a flash-cut in ILEC rates).

Moreover, while special access rates remain above TELRIC in many areas, there is every reason to believe that prices have dropped significantly over the past decade. This fact can be inferred from the significant loss of ILEC market share measured by total revenues in special access described above as well as from the fact that the ILECs have consistently set prices in the trunking basket below the PCI for that basket. It is also safe to assume that prices will continue to decline over time as entrants expand their offerings and new firms enter the market. This is now more likely than ever, since ILECs have received almost complete freedom from regulatory constraints in pricing special access in many MSAs.¹⁴

Furthermore, if the Commission were to establish price regulation that slowed and eventually reversed the current trend toward a more competitive special access market, it would

¹⁴ See *Verizon Petitions for Pricing Flexibility for Special Access and Dedicated Transport Services*, DA 01-663 (rel. Mar. 14, 2001) (granting end user channel termination Phase I relief in 13 MSAs and Phase II relief in 11 MSAs, special access and dedicated transport Phase I relief in five MSAs and one non-MSA study area, and Phase II relief in 40 MSAs and non-MSA areas); *Petition of Ameritech Illinois, Ameritech Indiana, Ameritech Michigan, Ameritech Ohio, and Ameritech Wisconsin for Pricing Flexibility*; *Petition of Pacific Bell Telephone Company for Pricing Flexibility*; *Petition of Southwestern Bell Telephone Company for Pricing Flexibility*, DA 01-670 (rel. Mar. 14, 2001) (granting end user channel termination Phase I relief in 18 MSAs and Phase II relief in four MSAs, special access and dedicated transport Phase I relief in 13 MSAs and Phase II relief in 28 MSAs); *BellSouth Petition for Phase I Pricing Flexibility for Switched Access Services*, FCC 01-76 (rel. Feb. 27, 2001) (granting switched access Phase I relief in eight MSAs); *BellSouth Petition for Pricing Flexibility for Special Access and Dedicated Transport Services*, DA 00-2793 (rel. Dec. 15, 2000) (granting end user channel termination Phase I relief in 37 MSAs and Phase II relief in 26 MSAs, special access and dedicated transport Phase I relief in 39 MSAs and Phase II relief in 38 MSAs).

only ensure further reliance on regulation in the future. In the absence of adequate levels of competition to discipline prices, purchasers of access circuits would continue to rely on regulators, rather than markets, to set prices. This is precisely the problem that Justice Breyer identified in his separate opinion in *AT&T v. Iowa Utils. Bd.* Justice Breyer pointed out in his concurrence as to the Court's decision to overturn the Commission's construction of the "impair" standard that unbundling obligations impose administrative costs and could well harm ILECs' incentive to innovate. *AT&T v. Iowa Utils. Bd.*, 525 U.S. 366, 429 (1999) (Breyer dissenting in part, concurring in part). As Justice Breyer further observed,

Nor are any added costs imposed by the more extensive unbundling requirements necessarily offset by the added potential for competition. Increased sharing by itself does not automatically mean increased competition. It is in the unshared, not the shared, portions of the enterprise that meaningful competition would likely emerge. Rules that force firms to share every resource and every element of a business would create not competition, but pervasive regulation, for the regulators, not the marketplace, would set the relevant terms.

Id. This is exactly the result that forcing prices down to the entry-detering price would have on the special access/dedicated transport market.

Furthermore, even if regulators could set prices based on an accurate assessment of the ILECs' forward-looking costs, purchasers of those services would still be harmed in the long run in the absence of a truly competitive market. This is because regulation can, at best, drive prices down close to an existing service providers' cost curve. This results in static efficiencies. But only competitive entry can lead to the introduction of new, lower cost curves. Such dynamic efficiencies obviously deliver greater benefits than any form of regulation, even regulation based on perfect information.

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In sum, the costs of lowering special access prices to TELRIC far outweigh any possible benefits. It is simply bad policy to seek to enhance short-term benefits of arbitrage when long-term efficiencies are possible. The Commission must trust the market in this case, and it must be patient. That patience will be rewarded in ways that increased resale competition cannot approach.

CONCLUSION

Based on the foregoing discussion, the Commission should establish the temporary limitation on the availability of UNEs for the provision of access as defined in the *Supplemental Order* as a permanent rule.

Respectfully submitted,

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