BEFORE THE

Federal Communications Commission

WASHINGTON, D.C.

In the Matter of	)	
	)	
Section 272(f)(1) Sunset of the BOC Separate	)	WC Docket No. 02-112
Affiliate and Related Requirements	)	

COMMENTS OF TIME WARNER TELECOM

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Time Warner Telecom Corporation ("TWTC"), by its attorneys, hereby submits these comments in response to the Notice of Proposed Rulemaking[1] in the above-referenced proceeding.

I. INTRODUCTION AND SUMMARY

In the *Non-Accounting Safeguards Order*, the Commission correctly concluded that the BOCs' overwhelming market power in the exchange access and local exchange markets causes the BOCs to have powerful incentives to engage in anticompetitive behavior. In particular, control over inputs, such as special access end-user connections and local transport needed by competitive providers of interLATA service, gives a BOC the incentive to discriminate against those competitors and in favor of its own interLATA business in the provision of those inputs. The BOCs' monopoly over switched local exchange and exchange access service in many areas gives the BOCs the incentive to misallocate the costs of largely unregulated interLATA service provided over the same facilities as the monopoly services. The Commission concluded in the *Non-Accounting Safeguards Order* that it would be impossible to adequately limit the BOCs'

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1 *See Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements*, Notice of Proposed Rulemaking, 17 FCC Rcd 9916 (2002) ("NPRM").

opportunities to act on these powerful incentives without the structural separation required by Section 272.

But in construing the requirements of Section 272, the Commission made sure to balance the competing goals of limiting the BOCs' opportunities to engage in anticompetitive behavior while at the same time giving the BOCs opportunities to establish economies of scope and scale to compete efficiently in the interLATA market. The Commission made significant concessions to enable BOCs to establish scope and scale efficiencies. Perhaps most importantly, the Commission allowed BOCs and Section 272 affiliates to provide marketing services to each other, even though the Commission openly recognized that this would give the BOCs an opportunity to misallocate the costs of interLATA service without detection and even though the Commission had not permitted such sharing of marketing services under the *Computer II* rules.

Two things are now clear five years after the release of the *Non-Accounting Safeguards Order*. First, there should be little doubt that the BOCs continue to possess substantial market power in the provision of end-user connections as well as local transport such that they continue to have the incentive to discriminate. Similarly, the BOCs continue to possess either a complete monopoly or substantial market power in the provision of local exchange and exchange access over large swaths of territory in states in which they have been granted Section 271 approval. The incentive to misallocate costs therefore remains in tact as well. Accordingly, Section 272 affiliates continue to play an indispensable role in limiting the BOCs' opportunities to engage in inefficient and anticompetitive behavior.

Second, the Section 272 affiliates have imposed only modest costs. The BOCs have absolutely no problem competing in the in-region interLATA marketplace. They have routinely gained about 25 percent of the relevant market within a year or two of gaining Section 271 approval in a state. Moreover, it is not even clear that the BOCs' main competitors in the long distance market can survive -- WorldCom being the most obvious example. Far from being stunted in their ability to compete, the BOCs may even be able to re-monopolize significant parts of the in-region interexchange market.

The Section 272 affiliate requirements should therefore be retained until the underlying causes of BOC inefficient incentives are eliminated. That is, a BOC should continue to be subject to separate affiliate requirements until it is deemed non-dominant in the provision of special access due to the development of facilities-based competition and is subject to enough competition in the local exchange market (either facilities-based or UNE-based) that it can no longer unilaterally raise local rates in a significant portion of the state.

Finally, it is critical to emphasize that, as important as Section 272 structural separation requirements are, they are not sufficient by themselves. The only way to diminish adequately the BOCs' opportunities to discriminate in the provision of special access to their competitors is to establish special access performance measurements and reporting requirements as well as associated penalties.

II. THE BENEFITS OF RETAINING SECTION 272 REQUIREMENTS ARE VERY SUBSTANTIAL.

Little has changed since the Commission concluded in the *Non-Accounting Safeguards Order* that the structural separation requirements in Section 272 are an indispensable means of limiting the BOCs' opportunities to act on their powerful incentives to discriminate against competitors in the provision of in-region interLATA service and to misallocate the costs of that service. Of particular importance to TWTC, which must purchase BOC special access end-user connections in order to provide interLATA frame relay, ATM, and other forms of data transmission service as well as conventional voice long distance service, market experience shows that BOCs continue to have strong incentives to discriminate in the provision of special access services to competitors. Section 272 separate affiliate requirements therefore continue to provide an extremely important protection against BOC anticompetitive behavior.

A. The BOCs Have Powerful Incentives To Discriminate Against Competitors In the Provision Of InterLATA Service.

BOCs continue to have market power over special access circuits.[2] Ample evidence of the BOCs' market power has been submitted by CLECs and underscored by the analysis and conclusions of several state commissions (including the New York Public Service Commission ("NYPSC")), this Commission, and the Circuit Court of Appeals for the District of Columbia. This data and these opinions confirm that, even in the most competitive markets -- including those where Phase II pricing flexibility has been granted -- competitors are still dependent upon incumbents for the provision of special access facilities.

State commissions, such as the NYPSC, agree that the ILECs remain the dominant providers of special access services. Last year, the NYPSC found that "Verizon dwarfs its

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[2] *See* Time Warner Telecom, *Ex Parte* Letter to Magalie Roman Salas, Secretary, FCC, CC Docket Nos. 96-98, 96-262 (filed Sept. 28, 2001); Time Warner Telecom, *Ex Parte* Letter to Jordan Goldstein, FCC (filed Dec. 4, 2001).

competitors" in the special access services market in New York.[3] Of the over 220,000 buildings in New York City that are mixed use, commercial, industrial, or public institutions, competitors have access to fewer than one-half of one percent (0.4 percent). *See NYPSC Order* at 7-8. Verizon is the sole provider for the remaining 99.6 percent.[4] These enormous disparities exist despite the fact that competition is more fully developed in LATA 132 than anywhere else in the state (or indeed, anywhere else in the nation). *See NYPSC Order* at 7; WorldCom *Ex Parte* at 4.

In other parts of New York City and the rest of the state, it is substantially more difficult and costly for CLECs to construct their own facilities.[5] Thus, CLECs are forced "to rely on [the ILECs'] ubiquitous local loop facilities" to provide service to a very high percentage of end users outside of the city. *NYPSC Order* at 7. Additionally, the NYPSC reports that it continues to receive numerous complaints from consumers regarding delays in installation of high speed data lines where Verizon is both the retail and wholesale provider. *Id.* at 8. The NYPSC concluded that the market competition data, combined with the consumer complaints, demonstrate that Verizon possesses market power over special access services in New York. *Id.* at 9-10.

Similarly, numerous competitors have demonstrated that they are dependent on the ILECs for last mile connections to the end user. TWTC, for example, constructs its own end-

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[3] State of New York Public Service Commission, *Opinion and Order Modifying Special Services Guidelines for Verizon New York Inc., Conforming Tariff, and Requiring Additional Performance Reporting*, Case 00-C-2051, Case 92-C-0665, Opinion No. 01-1, at 7 (rel. June 15, 2001) ("*NYPSC Order*").

[4] *See id* at 8; *see also* WorldCom *Ex Parte* Presentation, CC Docket No. 01-321, at 5 (filed Nov. 21, 2001) ("WorldCom *Ex Parte*").

[5] *See NYPSC Order* at 7 (noting that in other parts of New York City and the rest of the state, it is much more difficult for CLECs to serve customers using their own facilities because customers are more dispersed).

user connections whenever it is efficient and practical do so. But in a very significant percentage of cases, TWTC is precluded from constructing its own special access circuits, either because a customer's needs are not significant enough to justify construction, the end user's location is too far from the TWTC backbone to justify construction, the end user demands immediate installation at locations TWTC's network does not serve, or because TWTC cannot obtain access to the customer's building.

Other competitive providers have reported similar experiences. WorldCom, perhaps the largest competitive provider of special access circuits, has stated that it and other facilities-based CLECs remain "critically dependent on special access service provided by incumbent LECs to interconnect their networks and offer data, IP and other high bandwidth services." WorldCom *Ex Parte* at 1. Even though CLECs have invested billions of dollars in loops and transport facilities, the ILECs' facilities "remain the only means of connecting the vast majority of buildings." *Id.* WorldCom reports that in the most competitive MSAs, CLECs serve 13 percent of the buildings, while the ILECs serve the remaining 87 percent. *Id.* at 4. AT&T has also explained that it depends significantly on the ILECs for circuits connecting end-user locations.[6] As XO reported in August 2001, access to special access facilities "is critical for continued growth and development of local competition," and "it continues to remain highly dependent on

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[6] *See* AT&T Corp. Petition for Rulemaking to Establish Performance Standards, Reporting Requirements, and Self-Executing Remedies Needed to Ensure Compliance by ILECs with Their Statutory Obligations Regarding the Provision of Interstate Special Access Services, RM 10329, at 14-15 (filed Oct. 30, 2001) ("AT&T Petition for Rulemaking").

ILEC 'last mile' bottleneck facilities to serve end user customers."[7] Moreover, CompTel established a task force last year to investigate complaints regarding the declining service quality of special access that CLECs are receiving from ILECs.[8] This group consists of large users of ILEC special access services, all of whom are "critically dependent on ILEC-provided special access for a substantial portion of their special access needs." CompTel *Ex Parte* at 1. Collectively, this empirical and anecdotal data confirms that the ILECs continue to dominate the market for special access in a large number of areas.

The BOCs have repeated over and over their refrain that they lack market power in the provision of special access in those MSAs in which they have received pricing flexibility. But this assertion is baseless. Even in those MSAs where Phase II flexibility has been granted, the ILEC remains the sole provider of special access channel terminations for many point-to-point routes. The Commission recognized as much in the *Pricing Flexibility Order*. There it concluded that, even where an ILEC has received Phase II relief, it may still charge "an unreasonably high rate for access to an area that lacks a competitive alternative."[9] Indeed, ILECs are required to maintain their existing tariffed rates to preclude them from "abusing their

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[7] XO Communications, *Ex Parte* Presentation, CC Docket No. 96-98, at 4 (filed Aug. 24, 2001) ("XO *Ex Parte*").

[8] *See* CompTel, *Ex Parte* Presentation, CC Docket No. 96-98, at 1 n.1 (filed Aug. 20, 2001) ("CompTel *Ex Parte*").

[9] *Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Interexchange Carrier Purchases of Switched Access Services Offered by Competitive Local Exchange Carriers; Petition of US West Communications, Inc. for Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA*, Fifth Report and Order and Further Notice of Proposed Rulemaking, 14 FCC Rcd 14221, ¶ 144 (1999) ("*Pricing Flexibility Order*"), *aff'd, WorldCom, Inc. v. FCC*, 238 F.3d 449 (D.C. Cir. 2001).

market power by charging dramatically higher rates to customers that lack competitive alternatives." *Pricing Flexibility Order* ¶ 79 (emphasis added). For this reason, the Commission has refused to deem ILECs non-dominant in the provision of special access service, even after Phase II relief has been granted. *Id.* ¶ 151.

The Commission's brief in the appeal of the *Pricing Flexibility Order* further confirms that ILECs are the dominant providers of special access. There, the Commission was careful to note that the investment in collocation required by both Phase I and Phase II is insufficient by itself to justify eliminating safeguards designed to prevent unreasonably high rates (and, similarly, unreasonably poor service quality). Thus, the Commission explained that it "took steps to protect consumers under the relaxed Phase II regime."[10] Indeed, a central theme of the Commission's defense of the *Pricing Flexibility Order* on appeal was that, even in Phase II, "the Commission did not deregulate the ILECs but in fact retained tariffing and other requirements to restrain abuse of market power." FCC Brief at 29.

The court of appeals agreed with the Commission, finding that "the *Pricing Flexibility Order* expressly does 'not grant incumbent LECs all the regulatory relief … afford[ed] to non-dominant carriers.'"[11] One of the main reasons that the court upheld the competitive triggers in the *Pricing Flexibility Order* is that the Commission retained dominant carrier regulation of ILECs after Phase II relief is granted. Thus, far from recognizing that special access is

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10 Brief for FCC at 27, *WorldCom, Inc. v. FCC,* 238 F.3d 449 (D.C. Cir. 2001) (No. 99-1395) (and consolidated cases) ("FCC Brief").

11 *WorldCom, Inc. v. FCC*, 238 F.3d 449, 460 (D.C. Cir. 2001) (citing *Pricing Flexibility Order* ¶ 151).

competitive, the Commission's order is premised upon a finding that the ILECs continue to have market power over special access circuits.

The critical point for this proceeding is that the BOCs have the incentive to exploit their market power by engaging in both price and non-price discrimination in the provision of special access services. As the Commission has recognized, dominant firms have the incentive to raise their rivals' costs (and thereby force them to restrict output).[12] By raising rivals' costs, dominant firms -- like the ILECs in the special access market -- can keep prices well above cost without losing market share.

This can be achieved in two ways. First, an ILEC can raise the price that its competitor pays for an input. Dominant firms generally prefer this approach, since it allows them to make money while at the same time limiting their competitors' output. Moreover, where, as in the interLATA market, the BOC competes with the purchaser of special access in a downstream market, the BOC has the incentive to engage in price squeeze tactics by raising its wholesale price and lowering its retail prices. In those cases where regulation constrains a BOC's ability to engage in price discrimination, it will look to the second basic strategy for raising rivals' costs – unreasonable and discriminatory service quality.

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[12] *See Applications of Ameritech Corp. and SBC Communications Inc. for Consent to Transfer Control of Corporations Holding Commission Licenses and Lines Pursuant to Sections 214 and 310(d) of the Communications Act and Parts 5, 22, 24, 25, 63, 90, 95, and 101 of the Commission's Rules,* Memorandum Opinion and Order, 14 FCC Rcd 14712, ¶ 107 (1999) ("*SBC/Ameritech Order*"), *vacated on other grounds, Ass'n of Communications Enterprises v. FCC*, 235 F.3d 662 (D.C. Cir. 2001); *Review of Regulatory Requirements for Incumbent LEC Broadband Telecommunications Services,* Notice of Proposed Rulemaking, 16 FCC Rcd 22745, ¶ 29 (2001) (stating that "an incumbent LEC might improperly exercise its existing market power through cross-subsidization, raising its rivals costs, or improper discrimination.") (citations omitted).

Rather than viewing special access purchasers as "customers," ILECs now view CLECs and IXCs as existing and/or potential competitors for local market and toll revenues. The Commission has recognized as much in prior orders.[13] As the BOCs gain approval to enter the in-region interLATA market in more states, their incentives only worsen.[14] Nor does the Section 271 process do anything to correct these anticompetitive incentives. The Commission has expressly found that special access service is not covered by the competitive checklist.[15] Thus, the BOCs' incentive to discriminate in the provision of special access is very substantial and increasing. Until facilities-based competitors for special access services are able to offer a meaningful alternative to the BOCs in more than a select few large buildings in downtown areas, it is critical that mechanisms, such as separate affiliate requirements (and, as described below, performance measurements), are in place to deter these anticompetitive incentives.

Moreover, this is especially the case with regard to ILECs with large service areas such as SBC and Verizon. As the Commission has found, the larger an ILEC's network footprint, the

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[13] *See SBC/Ameritech Order* ¶ 107 ("[ILECs], which are both competitors and suppliers to new entrants, have strong economic incentive to preserve their traditional monopolies over local telephone service and to resist the introduction of competition that is required by the 1996 Act.") (citation omitted).

[14] *See* Marius Schwartz, *The Economic Logic for Conditioning Bell Entry into Long Distance on the Prior Opening of Local Markets*, 18 Journal of Regulatory Economics 247, 265-66 (Nov. 2000) ("Schwartz Paper").

[15] *See, e.g., Application by Bell Atlantic New York for Authorization Under Section 271 of the Communications Act to Provide In-Region, InterLATA Service in the State of New York,* Memorandum Opinion and Order, 15 FCC Rcd 3953, ¶ 340 (1999) ("*New York Order*"), *aff'd sub. nom., AT&T v. FCC*, 220 F.3d 607 (D.C. Cir. 2000) (finding that "[w]e cannot accept the assertion by a number of these parties that the provision of special access should be considered for purposes of determining checklist compliance.") (citation omitted); *Application by SBC Communications Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc. d/b/a Southwestern Bell Long Distance, Pursuant to Section 271 of the Telecommunications Act of 1996 to Provide In-Region, InterLATA Services in Texas*, Memorandum Opinion and Order, 15 FCC Rcd 18354, ¶ 335 (2000) ("*Texas Order*") (stating that "we do not consider the provision of special access services pursuant to a tariff for purposes of determining checklist compliance.") (citation omitted).

greater its incentive is to engage in anticompetitive behavior.[16] This is because a larger network footprint allows the ILEC to capture a greater share of the benefits of such behavior. For example, if an ILEC degrades the quality of a competitor's special access in one part of its service territory, that competitor may be disinclined to enter wherever the ILEC operates. The larger the ILEC's territory, the greater the benefit the ILEC gains from the CLEC's decision not to compete.

Finally, as TWTC explained in the Non-Dominance Proceeding, these negative incentives are highly relevant to the ATM and Frame Relay markets and are not limited to voice services.[17] Although the Commission has held that BOC Section 272 affiliates are non-dominant in the provision of interexchange ATM, Frame Relay, and other forms of interLATA data transmission, they continue to have market power over the end-user connections that competitors need to provide these services. Given that those services are generally provided on an interexchange basis, the BOCs must continue to be subject to structural separation, affiliate transaction, and nondiscrimination requirements in the provision of those services. These

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[16] *See SBC/Ameritech Order* ¶ 60 (observing that the merger "would increase the incentives and ability of the larger merged entity to discriminate against rivals in retail markets where the new SBC will be the dominant incumbent LEC. . . . The increase in the number of local areas controlled by SBC as a result of the merger will increase its incentive and ability to discriminate against [competing] carriers."); *Application of GTE Corp., Transferor, and Bell Atlantic Corp., Transferee, for Consent to Transfer Control of Domestic and International Sections 214 and 310 Authorizations and Application to Transfer Control of a Submarine Cable Landing License*, Memorandum Opinion and Order, 15 FCC Rcd 14032, ¶ 96 (2000) ("*Bell Atlantic/GTE Order*") (concluding that "the increase in the number of local calling areas controlled by Bell Atlantic as a result of the merger will increase its incentive and ability to discriminate against carriers competing in retail markets that depend upon access to Bell Atlantic's inputs in order to provide services.") (citation omitted).

[17] *See* TWTC Comments, CC Docket No. 01-337 at 10-13 (filed Mar. 1, 2002).

requirements are necessary to limit the BOCs' ability to leverage their control over bottleneck end-user connections to harm competition in downstream markets.

B. The BOCs Have The Incentive To Misallocate The Costs Of Providing InterLATA Service In A Manner That Will Harm Consumers And Competition.

The BOCs also continue to have strong incentives to cross-subsidize unregulated services offered over facilities that are used to provide services subject to rate regulation to the detriment of ratepayers and competition more broadly.[18] As the Commission has recognized, a BOC "may have an incentive to allocate improperly to its regulated core business costs that would be properly attributable to its competitive ventures."[19] The ultimate source of this incentive is the regulation of the BOC's local and access rates that the BOCs charge to customers for a service over which the BOCs have an unquestioned monopoly. As long as the BOCs retain their local monopoly and their local and access rates are regulated, they will look for ways to increase their rates by padding the regulated rate base.

Changes in rate regulation have not eliminated the incentive to cross-subsidize. Replacing rate of return regulation with price caps reduces but does not eliminate the incentive to

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18 As recently as October 1999, the Commission reaffirmed the need to retain regulations established under Section 272 designed to limit BOC opportunities to misallocate the costs of providing interLATA service. *See Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended,* Third Order on Reconsideration, 14 FCC Rcd 16299, ¶ 20 (1999) ("*Non-Accounting Safeguards Third Order on Reconsideration*"). *See also California v. FCC*, 905 F.2d 1217, 1224 (9th Cir. 1990); *Policy and Rules Concerning the Furnishing of Customer Premises Equipment, Enhanced Services, and Cellular Communications Services by Bell Operating Companies,* Report and Order, 95 FCC 2d 1117, 1138-52 (1983).

19 *Implementation of the Non-Accounting Safeguards of Section 271 and 272 of the Communications Act of 1934, as Amended,* First Report and Order and Further Notice of Proposed Rulemaking, 11 FCC Rcd 21905, ¶ 10 (1996) ("*Non-Accounting Safeguards Order*") (subsequent history omitted).

cross-subsidize. A regulated firm has the incentive to cross-subsidize an unregulated service where it can misallocate the costs of such service to the regulated side and be assured that it can raise prices (over the level that would otherwise apply under existing regulation) on regulated services and earn a profit on the misallocated costs.[20] Although price caps sever the immediate connection between costs and prices, they do not eliminate the connection. *See* Schwartz Paper at 263-64; *ILEC Classification Order* n.289. Rather, the inevitable periodic review of the reasonableness of price cap levels (such as the recent *CALLS* proceeding) causes regulators to review the rate of return an ILEC earns on investments. A high rate of return leads to the conclusion that prices are unreasonably high and must be reduced (exactly what occurred in *CALLS*).[21]

Thus, even under price caps, ILECs have the incentive to pad the rate base with artificial increases in costs to make it look as though they earn only a reasonable profit on regulated service. The result is that regulated ratepayers pay inefficiently high rates for their service and

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[20] *See Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area; Policy and Rules Concerning the Interstate, Interexchange Marketplace,* Second Report and Order in CC Docket No. 96-149 and Third Report and Order in CC Docket No. 96-61, 12 FCC Rcd 15756, ¶ 103, n.276 (1997) ("*ILEC Classification Order*"); *Non-Accounting Safeguards Order* ¶ 180. Moreover, this practice not only harms ratepayers but also harms competition in general by giving the incumbent an unfair advantage over its competitors. *See ILEC Classification Order* ¶ 103; Reply Comments of U.S. Dept. of Justice, CC Dkt. Nos. 96-149, 96-61 at 23-26 (filed Aug. 30, 1996).

[21] *See Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers, Low-Volume Long Distance Users, Federal-State Joint Board on Universal Service,* Sixth Report and Order in CC Docket Nos. 96-262 and 94-1; Report and Order in CC Docket No. 99-249; Eleventh Report and Order in CC Docket No. 96-45, 15 FCC Rcd 12962 (2000) ("*CALLS*") (subsequent history omitted). Importantly, the ILECs have for years argued that states must rebalance local rates so that residential rates are increased to a level that recovers the true cost of providing such service. *See, e.g.,* SBC Comments, CC Dkt No. 01-92, at 9-11 (filed Aug. 21, 2001). Such rate rebalancing would almost certainly cause state commissions to review the costs allocated to residential service. This fact again illustrates the immediate relevance of the incentive to misallocate costs to regulated services.

competition in the provision of unregulated service is distorted because the regulated firm has artificially low costs and can charge low prices regardless of whether its true costs would allow it to do so.

C. Separate Affiliate Requirements Are An Indispensable Means Of Limiting The BOCs' Opportunities To Act On These Powerful Incentives.

While the BOCs' incentives to engage in discrimination and cross-subsidy are powerful, their opportunities to act on these incentives cannot be adequately limited without structural separation of the local and access service provider from the interLATA service provider.

The source of the BOCs' market power is their control over bottleneck facilities and their ability to raise local exchange rates (by gaming the regulatory process) without losing market share. The appropriate means of addressing this market power is to regulate the upstream provider of the inputs needed by competitors in the downstream market. As the Commission has concluded, "applying dominant carrier regulation to an affiliate in a downstream market would be 'at best a clumsy tool for controlling vertical leveraging of market power by the parent, if the parent can be directly regulated instead.'" *ILEC Classification Order* ¶ 91 (citation omitted). Indeed, unwarranted dominant carrier regulation in a competitive retail market can in itself dampen competition. *See id.* ¶ 88. Only through regulation of the inputs needed in the downstream retail market can the Commission prevent BOCs from using "their market power in local exchange and exchange access services to engage in anticompetitive conduct in competitive markets." *Id.* ¶ 91.

Moreover, regulation of the upstream monopolist must take the form of a separate affiliate requirement to be effective. The Commission repeated this conclusion over and over in the *Non-Accounting Safeguards Order*. For example, the Commission concluded that the nondiscrimination requirements of Section 272 could only be meaningful where a BOC must provide in-region interLATA service through a separate affiliate that must obtain transmission and switching facilities from a BOC on an arm's length basis:

> Section 272(c)(1) and (e) require a section 272 affiliate to obtain services and facilities on the same rates, terms, and conditions available to unaffiliated entities. Contrary to the suggestion of some commenters, those nondiscrimination safeguards *would offer little protection if a BOC and its section 272 affiliate were permitted to own transmission and switching facilities jointly*. To the extent that a section 272 affiliate jointly owned transmission and switching facilities with a BOC, the affiliate would not have to contract with the BOC to obtain such facilities, thereby precluding a comparison of the terms of transactions between a BOC and a section 272 affiliate with the terms of transactions between a BOC and a competitor of the section 272 affiliate. *Together*, the prohibition on joint ownership of facilities and the nondiscrimination requirements should ensure that competitors can obtain access to transmission and switching facilities equivalent to that which section 272 affiliates receive.

Non-Accounting Safeguards Order ¶ 160 (emphasis added).

Separate ownership of land and buildings where transmission and equipment are located was also deemed necessary to limit the opportunities for discrimination. Such separate ownership "should ensure that collocation agreements between a BOC and its section 272 affiliate are reached pursuant to arm's length negotiations and that the same collocation opportunities are available to similarly situated non-affiliated entities." *Non-Accounting Safeguards Order* ¶ 161.

Similarly, the Commission also decided that the prohibition on allowing the same personnel to perform the operating, installation, and maintenance services for equipment owned or leased by a BOC and its Section 272 affiliate was "*necessary* to ensure that a BOC complies with the nondiscrimination requirements of section 272." *Non-Accounting Safeguards Order* ¶ 163 (emphasis added). Indeed, "[a]llowing a BOC to contract with the section 272 affiliate for operating, installation, and maintenance of services would *inevitably* afford the affiliate access to the BOC's facilities that is superior to that granted to the affiliate's competitors." *Non-Accounting Safeguards Order* ¶ 163 (emphasis added).

Moreover, the Commission concluded that the Section 272 separate affiliate requirement is essential to limit the BOCs' opportunities to engage the misallocation of the costs of providing in-region interLATA service. This is particularly true with regard to the requirement that the BOC and the Section 272 affiliate not jointly own transmission and switching equipment. As the Commission explained,

> [i]mposing a prohibition on such joint ownership [of switching and transmission equipment] also avoids the need to allocate the costs of such transmission and switching facilities between BOC activities and the competitive activities in which a section 272 affiliate may be involved. We agree with the claims of some commenters that, because the costs of wired telephony networks and network premises are largely fixed and largely shared among local, access, and other services, sharing of switching and transmission facilities may provide a significant opportunity for improper allocation of cost between the BOC and its section 272 affiliate.

Non-Accounting Safeguards Order ¶ 159.

These conclusions demonstrate the extremely important role of Section 272 affiliates in the current market environment. As explained, there should be little doubt that the BOCs continue to have powerful incentives to discriminate against competitors in the provision of interLATA service and to misallocate the costs of its own interLATA service. Where this is the case, a necessary precondition to limiting the BOCs' opportunities to act on these incentives is to retain the separate affiliate requirements (although, as explained below, the Commission must also adopt performance requirements for its regulatory regime to be sufficient).

III. SECTION 272 SEPARATE AFFILIATE REQUIREMENTS HAVE NOT IMPOSED SIGNIFICANT COSTS.

While the Section 272 requirements have provided a critically important means of limiting BOC opportunities to engage in anticompetitive behavior, they have not at the same time imposed significant costs in terms of lost efficiencies. Both the Commission's rules implementing Section 272 and market experience demonstrate this fact.

To begin with, the Commission consciously chose to implement the Section 272 affiliate requirements in a manner that offers the BOCs significant opportunities to establish economies of scale and scope, even while the separate affiliate requirements remain in place. The Commission described its approach to implementing Section 272 as follows:

> Because the BOC has the incentive to provide its affiliate with the most efficient access, the statute requires the BOC to provide competitors the same access. Access to such inputs on nondiscriminatory terms will enable a new entrant to compete effectively, assuming it is at least as efficient as the BOC and/or its section 271 affiliate. At the same time, Congress also was sensitive to the value of the BOCs of potential efficiencies stemming from economies of scale. Our task is to implement section 272 in a manner that ensures that the fundamental goal of the 1996 Act is attained -- to open all telecommunications markets to robust competition -- but at the same time does not impose requirements on the BOCs that will unfairly handicap them in their ability to compete.

Non-Accounting Safeguards Order ¶ 13. The Commission calibrated the extent to which BOCs must function separately from their Section 272 affiliates in a manner that comports with this balanced approach.

For example, rather than establish a blanket prohibition on the joint ownership of equipment and property between a BOC and its Section 272 affiliate, the Commission limited the joint-ownership prohibition to transmission and switching equipment and the land and buildings where those facilities are located. *Id.* ¶ 162. The Commission tailored its approach in this manner because it found "that joint ownership of other property, such as office space and equipment used for marketing or the provision of administrative services, may provide economies of scale and scope without creating the same potential for discrimination by the BOCs." *Id.*

Nor did the Commission impose a blanket prohibition on BOC and Section 272 affiliate employees performing work for each other (what the Commission refers to as the "sharing" of services[22]). Instead, the Commission stated that "we believe the economic benefits to consumers from allowing a BOC and its section 272 affiliate to derive the economies of scale and scope inherent in the integration of some services outweigh any potential for competitive harm created thereby. Therefore, we permit the sharing of administrative and other services." *Id.* ¶ 168. For example, the Commission allows a BOC and its Section 272 affiliate to provide marketing services (*id.* ¶ 183) and administrative services (*id.*¶ 168) to each other. The Commission also allows a BOC to develop services for or with its Section 272 affiliate, so long as the BOC also performs these functions with unaffiliated long distance carriers. *Id.* ¶ 169. Similarly, the Commission allows a BOC and its Section 272 to obtain services from the same outside supplier. *Id.* ¶ 184.[23]

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22 The "'sharing of services' means the provision of services by the BOC to its section 272 affiliate, or vice versa." *Non-Accounting Safeguards Order* ¶ 178.

23 In addition to the flexibility the Commission built into the design of the Section 272 regime, the statute itself allows the BOCs to achieve certain economies of scale and scope by exempting all so-called "incidental

Importantly, in designing the Section 272 requirements, the Commission quite consciously offered BOCs and Section 272 affiliates more significant opportunities to establish economies of scale and scope than was permitted under *Computer II*[24] and other analogous separate affiliate regimes established by the statute and Commission regulations. For example, BOCs and *Computer II* affiliates were not allowed to provide marketing services to each other, while, as mentioned, this is not the case with regard to BOCs and Section 272 affiliates. *See Computer II* ¶ 239. It is also significant that a Section 272 affiliate may construct, own and operate its own network facilities, including local facilities (*Non-Accounting Safeguards Order* ¶ 169), while *Computer II* affiliates were not permitted to own any network or local distribution transmission facilities or equipment. *See Computer II* ¶ 229. The Commission also construed Section 272 not to require the level of separation mandated for electronic publishing under Section 274(b). *See Non-Accounting Safeguards Order* ¶ 157.

Moreover, the Commission adopted its Section 272 rules even though it recognized that the substantial level of sharing it created a very real risk that the BOCs would be able to engage in undetected cost misallocation. As the Commission explained, "[w]e recognize that allowing the sharing of in-house services will require a BOC to allocate the costs of such services between the operating company and its section 272 affiliate and provide opportunities for improper cost

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interLATA services" that are also telecommunications services and all previously authorized interLATA services from the separate affiliate requirement. *See* 47 U.S.C. § 272(a)(2)(B); *Non-Accounting Safeguards Order* ¶¶ 92-98.

[24] *See Amendment of Section 64.702 of the Commission's Rules and Regulations (Second Computer Inquiry)*, Final Decision, 77 FCC 2d 384 (1980) ("*Computer II*") (subsequent history omitted).

allocation, exchanges of information, and discriminatory treatment." *Non-Accounting Safeguards Order* ¶ 178.

All of this demonstrates that the Commission went out of its way to ensure that the Section 272 affiliate requirements would not unduly hinder the BOCs' ability to compete efficiently in the provision of in-region interLATA service. The BOCs' success in gaining long distance market share in the states in which they have received Section 271 approval demonstrates that they have not been harmed by Section 272 requirements. For example, SBC already has a 29.5 percent share of the long distance market in six states -- the five Southwestern Bell states where it has been granted Section 271 authority and Connecticut.[25] By contrast, WorldCom/MCI -- the pioneer in long distance competition -- has never been able to achieve this level of market share.[26] Verizon reports similarly impressive gains, with 30 percent market share in New York and Massachusetts.[27] Verizon is now the fourth largest IXC in the country.[28] In the first five weeks of providing long distance in Georgia and Louisiana, BellSouth already had 147,000 long distance customers, four percent of BellSouth's residential local exchange customers in the two states.[29] Indeed, the independent IXCs' precipitous financial decline

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25 *See SBC Communications Reports Second-Quarter Earnings of $0.55 Per Diluted Share; $0.61 Per Diluted Share Before Special Items*, SBC Investor Briefing at 6 (July 23, 2002).

26 *See Statistics of the Long Distance Telecommunications Industry*, Industry Analysis Division, FCC at 17 (Jan. 2001) (showing that MCI WorldCom's market share peaked at 25.7 percent between 1984 and 1999).

27 *See* Verizon Communications, Inc., News Release, *Strong Operational Results Highlight Second-Quarter Financial Performance at Verizon Communications* (July 31, 2002).

28 *See* Verizon Communications, Inc., News Release, *Verizon Reports Solid First-Quarter Adjusted EPS of 72 Cents in Challenging Economic Environment -- 2002 Outlook Updated* (Apr. 23, 2002).

indicates that the BOCs could well re-monopolize significant portions of the long distance market in the near future.

Thus, the Section 272 rules offer the BOCs and their affiliates very significant opportunities to develop economies of scale and scope. Their success in the marketplace thus far demonstrates that they are in no way precluded from competing effectively while the Section 272 affiliate requirements remain in place. Accordingly, the costs in terms of foregone efficiencies and competition imposed by the Section 272 requirements have been minimal.

IV. THE COMMISSION SHOULD RETAIN SECTION 272 AFFILIATE REQUIREMENTS UNTIL A BOC IS NON-DOMINANT IN THE PROVISION OF SPECIAL ACCESS AND HAS SUBSTANTIALLY DIMINISHED ABILITY TO UNILATERALLY RAISE PRICES FOR LOCAL EXCHANGE SERVICE IN A STATE.

As explained, the source of the BOCs' incentive to engage in discrimination and cross-subsidy is their market power in the exchange access and local exchange markets.[30] As also explained, the benefits of retaining separate affiliate requirements while the BOCs continue to possess this market power are very significant and the costs are relatively modest. It follows that the Commission should retain the Section 272 requirements until such time as a BOC's market power is substantially lessened in a particular state.

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[29] *See* BellSouth Corporation, Press Release, *BellSouth Reports Second Quarter Earnings* (July 22, 2002).

[30] "In adopting rules in this proceeding, however, our goal is to ensure that BOCs do not use their control over local exchange bottlenecks to undermine competition in the new markets they are entering -- interLATA services and manufacturing. The section 272 safeguards, among other things, are intended to protect competition in these markets from the BOCs' ability to use their existing market power in local exchange services to obtain an anticompetitive advantage." *Non-Accounting Safeguards Order* ¶ 206.

The Commission repeatedly recognized in the *Non-Accounting Safeguards Order* that the Section 272 requirements remain essential unless and until a BOC's market power is significantly diminished by competition. For example, the Commission explained that,

> [i]n enacting section 272, Congress recognized that the local exchange market will not be *fully competitive* immediately upon its opening. Congress, therefore, imposed in section 272 a series of separate affiliate requirements applicable to the BOCs' provision of certain new services and their engagement in certain new activities. These requirements are designed, *in the absence of full competition* in the local exchange marketplace, to prohibit anticompetitive discrimination and cost-shifting, while still giving consumers the benefit of competition.

Non-Accounting Safeguards Order ¶ 9 (emphasis added). Moreover, the Commission clarified that resale (or UNE-P) competition was insufficient to reduce the BOC's market power, at least insofar as that market power gives the BOC the incentive to discriminate. As the Commission stated, "[t]he rules and policies adopted in this order seek to preserve the carefully crafted statutory balance to the extent possible until *facilities-based alternatives* to the local exchange and exchange access services of the BOCs *make those safeguards no longer necessary*." *Id.* ¶ 13 (emphasis added).

The unavoidable implication is that BOCs should only be relieved of the Section 272 requirements when their market power in the upstream market is substantially reduced. With regard to special access, this means that facilities-based competition has developed enough that the BOC must be deemed non-dominant in the provision of special access in the relevant geographic markets (likely the MSAs in a state). With regard to the local exchange market, this means that local competition (facilities-based and UNE-based) has developed enough that the

BOC's ability to unilaterally raise price has been eliminated in a significant portion of the state in question.

This approach is fully consistent with the structure and language of Section 272. As explained, behavioral requirements by themselves would be ineffective in the face of the ILECs' existing powerful incentives to discriminate and cross-subsidize. Structural separation must therefore continue to be required until those incentives are diminished. It would be patently in conflict with the Commission's conclusions in the *Non-Accounting Safeguards Order* to eliminate structural separation and rely on behavioral requirements while the BOCs retain their current incentives.

But it is also logical that the requirements of Section 272(e)(1) and (2) (which are not subject to the sunset provision) might continue to apply even after the BOCs are subject to substantial competition in the special access and local exchange markets. *See* 47 U.S.C. §§ 272(e)(1), (e)(2). Those provisions establish nondiscrimination obligations on a BOC's provision of exchange and exchange access service and a cost imputation requirement on a BOC's provision of in-region interLATA service. These requirements remain relevant even after a BOC is non-dominant in the provision of special access and is subject to competition in the provision of local exchange service. Given the "third-party pays" problem associated with the provision of switched access (a problem that caused the Commission to regulate even CLEC access charges), a BOC will continue to possess market power over the provision of switched access to a very large percentage of end users in a state even after it is subject to substantial competition in the local market. The BOC will therefore continue to have the incentive to engage in both non-price discrimination (*e.g.*, slow rolling PIC changes) and price (*e.g.*, price squeeze tactics) discrimination against its rivals in the provision of interLATA service. The Section 272(e)(1) and (3) prohibitions against this type of behavior will therefore remain relevant.

Finally, lest there be any doubt about the matter, the Commission's decision to allow the separate affiliate requirement for interLATA information services to sunset has no bearing on the instant proceeding. As a general matter, information services offer the BOCs fewer opportunities to discriminate than is the case with interLATA telecommunications services. Discrimination is less likely because information service providers generally do not need to require the same level of complexity and integration in their interconnection arrangements with ILECs as do interLATA telecommunications service providers. Information service providers have long been able to connect to the ILEC network by merely purchasing local business line connections, a relatively simple form of network interconnection in which the provisioning arrangements, while certainly offering opportunities for discrimination, are at least relatively well-established. Long distance carriers, on the other hand, require interconnection arrangements that offer many more opportunities for subtle and blatant discrimination. Unlike information service providers, many competitive providers of long distance service (such as TWTC in the case of long distance data service), require collocation. As discussed, this is an input that offers numerous opportunities for discrimination that, in the absence of separate affiliate requirements, are likely to go largely undetected. In addition, the exchange of telecommunications traffic generally requires access to complex and technologically dynamic signaling systems and associated databases that offer an endless supply of opportunities for discrimination. Information service providers generally do not need to obtain access to these inputs. Finally, competitive providers of telecommunications services also must often integrate their operations support systems with those of the ILECs for the purpose of obtaining access to pieces of the ILEC network that the competitor cannot itself deploy. Whether those inputs are purchased as special access, as is the case with TWTC, or as UNEs, the need to purchase them again presents an ever-growing list of ILEC opportunities to deny, delay and degrade access. Again, information service providers generally do not need to purchase these inputs.

V. THE COMMISSION MUST ADOPT SPECIAL ACCESS PERFORMANCE MEASUREMENTS, STANDARDS, REPORTING REQUIREMENTS, AND PENALTIES TO ENSURE THAT THE BOCS DO NOT EXPLOIT THEIR EXISTING MARKET POWER.

While there should be no question that the Commission must retain the Section 272 separate affiliate requirements until the BOCs lose their market power in the provision of local exchange and exchange access, those separate affiliate requirements are not enough by themselves. Performance requirements must also be established for special access wholesale provisioning.

The Commission has already determined that some reporting requirements are essential for the enforcement of Section 272 behavioral requirements. For example, Section 272(e)(1) states that a BOC and a BOC affiliate subject to Section 251(c) "shall fulfill any requests from an unaffiliated entity for telephone exchange service and exchange access within a period no longer than the period in which it provides such telephone exchange service and exchange access to itself or to its affiliates." 47 U.S.C. § 272(e)(1). The Commission determined that this provision could not be enforced unless the BOCs provide reports on the time it takes them to fulfill local exchange and exchange access requests for themselves and their affiliates. As the Commission explained, absent such reports, "the information necessary to detect violations of [Section 272(e)(1)] will be unavailable to unaffiliated entities." *Non-Accounting Safeguards Order* ¶ 242. Moreover, as the Commission explained, "[i]f competitors can easily obtain data about a BOC's compliance with section 272(e)(1), this increases the likelihood that potential discrimination can be detected and penalized; this in turn, decreases the danger that discrimination will occur in the first place." *Id.* ¶ 243. Nor was the Commission persuaded by the BOCs' argument that discrimination was not likely because their provisioning and maintenance systems are designed not to differentiate among those receiving service: "Although the BOCs' use of nondiscriminatory, automated order processing systems is important for meeting the requirements to Section 272(e)(1), the existence of these systems does not guarantee that requests placed via these systems are actually completed within the requisite period of time." *Id.*

Notwithstanding these conclusions, the Commission has not gone nearly far enough in the area of establishing performance reporting, measurements, and penalties to ensure compliance with either the letter or the spirit of Section 272. To begin with, although the Commission determined that, in principle, BOCs should be required to provide reports regarding the provision of exchange access and local exchange service to themselves and their affiliates, no specific rules were ever established to implement that decision.[31] The Commission determined

[31] In the *Non-Accounting Safeguards Third Order on Reconsideration*, the Commission determined that it was not yet ready to establish reporting requirements under Section 272(e)(1). *See Non-Accounting Safeguards Third Order on Reconsideration* ¶¶ 33-35. Of course, the Commission has relied heavily on performance

that the term "requests" in Section 272(e)(1) "should be interpreted broadly, and that it includes, but is not limited to, initial installation requests, subsequent requests for improvement, upgrades or modifications of service, or repair and maintenance of these services." *Id.* ¶ 239. This list of functionalities is simply too vague a basis for establishing specific reporting requirements. In addition, the Commission did not require that the BOCs report on the timeliness of their provision of exchange access and local exchange service for unaffiliated carriers. Yet absent such a requirement, a competitor is unlikely to be able to "obtain data about a BOC's compliance with section 272(e)(1)." This is because BOC internal measurements for reporting are likely to differ from those used by a competitor, thus leading to endless disputes regarding whether the data yields apples-to-apples comparisons. In addition, only the BOCs have access to the level of performance provided to all competitors (which is essential to determining whether a BOC is discriminating among competitors).

Furthermore, the Commission has construed the language of Section 272 nondiscrimination provisions to address only those functions that BOCs provide themselves or their affiliates.[32] Those provisions do not address wholesale functionalities the BOCs provide to competitors that are different from the functionalities the BOCs provide to themselves and their

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measurements, reporting, and associated penalties to ensure compliance with the requirement of Section 251. *See, e.g., New York Order* ¶¶ 63-366; *SBC/Ameritech Order* ¶¶ 377-380. The Commission has also wisely commenced a proceeding to establish similar performance requirements for special access. *See Performance Measurements and Standards for Interstate Special Access Services*, Notice of Proposed Rulemaking, 16 FCC Rcd 20896 (2001).

[32] *Non-Accounting Safeguards Order* ¶ 204 (construing Section 272(c)(1) to require only "that unaffiliated entities receive the same treatment as the BOC gives to its section 272 affiliate"); *id.* ¶¶ 239-240 (characterizing Section 272(e)(1) as addressing only requests from unaffiliated carriers that are "equivalent" to services provided by the BOC to itself or its affiliates).

affiliates. This is a critical omission, since the BOCs have argued strenuously that the wholesale services they provide for competitors are different from the services that they provide to themselves or their affiliates.[33]

In sum, comprehensive performance measurements and reporting requirements (as well as penalties for failure to meet these requirements) are necessary to enforce the requirements of Section 272 and to address wholesale functionalities not addressed by that provision. The Commission must therefore establish performance requirements for special access.

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[33] *See, e.g.,* Verizon Comments, CC Docket No. 01-321 at 14-19 (filed Jan. 22, 2002).

VI. CONCLUSION

The Commission must retain its Section 272 affiliate requirements until a BOC is non-dominant in the provision of special access service and faces substantial competition in the provision of local service in a particular state.

Respectfully submitted,

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