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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington D.C. 20554

In the Matter of AT&T Corp. Petition for Rulemaking To Reform Regulation Of Incumbent Local Exchange Carrier Rates For Interstate Special Access Services	)	WC Docket No. 02-

PETITION FOR RULEMAKING

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Pursuant to Section 1.401 of the Commission's Rules, 47 C.F.R. § 1.401, AT&T Corp. ("AT&T") hereby requests that the Commission promptly initiate a rulemaking to reform regulation of price cap incumbent local exchange carrier ("ILEC) rates for interstate special access services. **As** detailed below, there is now indisputable proof that: (i) large ILECs, and particularly the Bell Operating Companies ("Bells"), retain pervasive market power in the provision of these services, (ii) the large ILECs are abusing that market power with patently unjust and unreasonable rates that impose a multi-billion dollar annual overcharge or tax on American businesses and consumers and also severely harm both local and long distance competition, (iii) the Commission's existing rules are incapable of addressing this worsening crisis, and, indeed, only exacerbate the problem, and (iv) the Commission therefore has a clear legal obligation promptly to reform its regulation to protect the public interest and to put an end to these monopoly abuses.

INTRODUCTION AND SUMMARY

The Commission has been duped. For several years now, the Bells have been peddling the story that they face substantial competition in the provision of high capacity loops and transport and that the only appropriate Commission response is reduced regulation and greater reliance upon market forces. In order to "meet competition" from many alternative suppliers of loops and transport, the Bells have argued, they have an urgent need to escape rate regulation of their own special access services.

The Bells' approach to selling their special access tale has been quite clever. Early on, they recognized the futility of attempting to supply evidence of actual competition that creates market forces adequate to constrain their power over price. The marketplace reality is that, despite limited, targeted entry, price-constraining levels of competition in the provision of special access services simply did not (and do not) exist in any local market, as even regulators in the local markets with the *most* competitive activity have recently held. Thus, although the Bells knew full well that they were (and are) the *only* suppliers of high capacity local links to the vast majority of buildings, they proffered the novel, and, at the time, largely unverifiable, theory that the existence of some collocation in some of a Bell's central offices in an area signals sufficient competition to justify rate flexibility and, ultimately, rate deregulation. Without access to the contrary facts in the Bells' sole possession, the Commission made a predictive judgment that the Bells' theory was sound, and, noting the great deference owed to such predictive judgments, the court of appeals affirmed.

The Bells responded with a torrent of "pricing flexibility" requests, and, to no one's great surprise, they had little trouble meeting the "competitive triggers" that had been adopted. Today, more than half of the Bells' special access revenues come from areas in which they are no longer subject to price cap regulation. On current trends, special access rate deregulation will be all but complete by the end of next year.

That would have the makings of a great regulatory success story, but for the unfortunate fact that the Bells' own subsequent actions and submissions to the Commission have exposed their story – and the entire foundation of reduced regulation of their special access rates – as a fraud. The Bells' claims that their rates are constrained by market forces were false when made, are false today, and will remain false for the foreseeable future. The Bells have not used rate deregulation to meet competition, but to gouge both their captive special access customers and the general public. The Bells' already exorbitant special access rates and revenues have soared, and the ever-increasing annual returns that the Bells enjoy on those services are now as much as 50 *percent* or more. The Bells' special access windfalls already represent at least a ***$5** billion* annual direct tax on American businesses and consumers, and the problem is only worsening. The Bells' unjust – and, as compared to the Bells' own costs of accessing the underlying facilities, patently discriminatory – special access rates are also among the greatest threats to both local and long distance competition. In short, special access rates that have long been a problem have now become an industry crisis that portends irreversible harm to competition and consumers. Immediate Commission action is imperative.

The relevant facts are straightforward and indisputable. As the Bells' own ARMIS reports confirm, their special access returns – and hence the special access rates that have produced those returns – are, without exception, both grossly excessive and rapidly rising. Indeed, the colossal returns reflected in the Bells' *embedded cost* ARMIS data greatly understate the Bells' windfalls. Comparing the Bells' special access revenues to their true economic costs of providing those dominant carrier services reveals that their annual returns are simply obscene

– rates are more than *double* costs. In ***every*** area in which they have received pricing flexibility, the Bells have avoided the substantial "X-Factor" productivity reductions that would otherwise have been required in the absence of pricing flexibility, and either maintained rates at previous levels or raised rates still further. And, as further confirmation of their enduring market power, the Bells have managed to *increase* their special access sales even as they continue to inflate the rates for those services and to provide their unaffiliated special access customers with remarkably poor (and often deteriorating) performance in delivering those services. Indeed, the Bells' special access revenues have more than tripled since 1996. By any standard, these facts alone establish that the Bells retain considerable power over price, that neither market forces nor the existing regulatory scheme constrains that power, and that existing special access rates are unjust and unreasonable.

The resulting harm to consumers and competition is immense. The dwindling ranks of competing local carriers must, of course, pass on to consumers the Bells' special access rate increases. By charging other carriers these inflated rates, the Bells also avoid retail price competition. This is not lost on business and consumer groups, which are increasingly voicing their opposition to the Bells' special access abuses, most recently in Commission proceedings directed at the other primary outlet of the Bells' special access market power, discriminatory provisioning and poor performance. The Bells' special access rates are, if anything, an even bigger problem. In generating billions of dollars of windfalls each year, the Bells' special access "tax" places a substantial drag on the nation's economy.

But the harm from failing to curb the Bells' special access market power runs much deeper The Bells' high capacity loops and transport, which are characterized by enormous economies of scale (and sunk costs), remain essential inputs for competitive local exchange carriers ("CLECs"). Although Congress addressed that reality by requiring the Bells to lease those facilities at forward-looking economic costs, the Bells evade that obligation through the "use" and "commingling" restrictions that the Commission has allowed them to impose on competitors, and thus CLECs have no choice but to pay the Bells' exorbitant special access rates. That gives the Bells, which access those same facilities at their much lower economic costs, an enormous cost advantage in competing to serve both business and residential customers. Worse yet, pricing flexibility (both "Phase I" contract tariffs and "'Phase II" rate deregulation) allows the Bells to use anticompetitive price discrimination and profitably to target with predatory rates the small minority of buildings where CLECs might otherwise have a fighting chance. Real customer choice cannot be sustained under these circumstances.

The Bells' unlawful special access rates are equally destructive of long distance competition. Local access is, of course, an essential input for long distance services, and, as the Commission has expressly recognized, absent regulation, the Bells have both the incentive and ability to use inflated access charges to "price squeeze" their long distance competitors. In the past, the Commission has pointed to price cap regulation and network element substitutes for access as checks on Bell price squeezes, but those are obviously no checks at all in the face of rate deregulation and use and commingling restrictions. If the Bells' long distance rivals must continue to pay more than twice the Bells' own forward-looking economic costs of local access, remonopolization is inevitable.

There is only one responsible and lawful Commission solution to this special access crisis. The Commission has ample authority to, and must, initiate a rulemaking and, on an expedited basis, reform and tighten its special access rate regulations to the full extent necessary to protect consumers and competition and to curb the Bells' existing ability to impose unjust, unreasonable and discriminatory charges for their special access services. At a minimum, the Commission should revoke pricing flexibility and reinitialize price caps to levels designed to produce normal, rather than monopoly, returns. Moreover, existing special access rates are so far out of line with lawful, compensatory levels that the Commission should, as an interim measure, (1) reduce all special access rates subject to Phase II pricing flexibility to levels that would produce an 11.25% rate of return, and (2) impose a moratorium on consideration of further pricing flexibility applications pending completion of the rulemaking. In addition, the Commission should specify that access purchasers may take advantage of this interim relief without triggering any termination liabilities or other penalties in the Bells' optional pricing plans.

This course of action can no longer be considered discretionary. The Communications Act requires that all charges in connection with common carrier services be just and reasonable, 47 U.S.C. § 201, and it is well established that the Commission has a duty to enforce that requirement. There are no circumstances under which permitting the Bells to earn such "creamy returns" at the public's expense could be squared with these requirements.[1] But, as the courts have stressed, where, as here, the Commission has based its existing regulatory regime on a predictive judgment, it is absolutely imperative that "the Commission . . . vigilantly monitor the consequences of its rate regulation rules."[2] "If, in light of the actual market developments, the Commission determines that competition is not having the anticipated effect on access charges," it must "revisit the issue."[3] The existing relaxed (and, to a large extent, now nonexistent) rate

[1] *Farmers Union Cent. Exchange, Inc.* v. *FERC*, 734 F.2d 1486, 1502-03 (D.C. Cir. 1984) ("*Farmers Union II*").

[2] *American Civil Liberties Union* v. *FCC*, 823 F.2d 1554, 1565 (D.C. Cir. 1987)

[3] ***Texas** Office of Public Utility Counsel* v. *FCC*, 265 F.3d 313, 325 (5th Cir. 2001); ***see** also* *SWBT* v. *FCC*, 153 F.3d 523, 547 (8th Cir. 1998) (same); ***see** also CELLNET* v. *FCC*, 149 F.3d

regulation of interstate special access reflects predictive judgments that market forces would constrain the Bells' special access pricing. It is now clear that those predictions were wrong and that rate regulation is, and, for the foreseeable future, will remain, vitally necessary to combat the Bells' market power and to ensure that special access charges are just, reasonable and nondiscriminatory.

It is no answer to point out that the Bells' captive customers could file Section 208 complaints to address the Bells' abuses in each of the hundreds of **MSAs** in which they provide special access services. **As** the D.C. Circuit has warned, the existence of such a "safety valve" is no defense to a claim that the underlying regulatory regime is unlawful.[4] There is accordingly no scenario in which the Commission lawfully can avoid addressing the special access crisis, and AT&T strongly urges the Commission promptly to initiate the rulemaking sought by this petition

I. THE BELLS' SPECIAL ACCESS RATES ARE GROSSLY EXCESSIVE AND UNLAWFUL AND ARE BECOMING MORE SO.

It can no longer be disputed that the Bells' special access rates are unjust and unreasonable and that these unlawful rates are not random or temporary occurrences. Rather, fundamental marketplace and regulatory conditions are driving a consistent, industry-wide trend resulting in higher and higher rates of return every year for each Bell holding company. It is equally clear that the Commission's existing scheme of rate regulation is not responding to this

429, 442 (6th Cir. 1998) ("If the FCC's predictions about the level of competition do not materialize, then it will of course need to reconsider its [regulations] in accordance with its continuing obligation to practice reasoned decisionmaking"); *Bechtel* v. *FCC*, 957 F.2d 873, 881 (D.C. Cir. 1992) (it is "settled law that an agency may be forced to reexamine its approach if a significant factual predicate of a prior decision . . . has been removed.").

[4] *See, e.g., Time Warner Entertainment* Co. v. *FCC*, 56 F.3d 151, 176 (D.C. Cir. 1995).

BellSouth	49.26%
Qwest	46.58%
SBC	54.60%
Verizon	21.72%
Verizon (excluding NYNEX)	37.08%

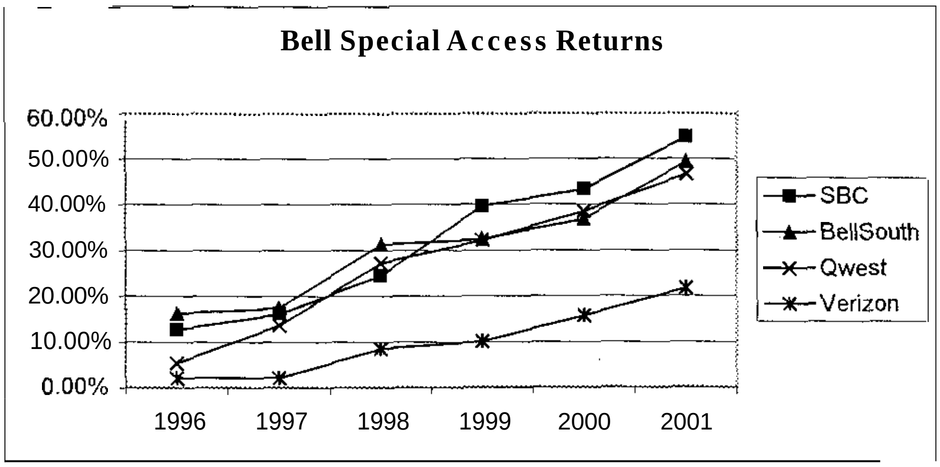
These extraordinarily excessive returns are no aberration; the Bells are fleecing special access customers nationwide, and, by doing so, are reaping shocking windfalls. For example, SBC's special access revenues in 2001 exceeded amounts that would have produced an 11.25% rate of return by an astonishing $2.5 billion. For the same year, Verizon, BellSouth, and Qwest reaped special access windfalls of more than $1 billion, $966 million, and $710 million, respectively. Thus, for 2001 alone, the Bells' excessive special access rates were equivalent to a more than ***$5** billion tax* on American businesses

These patently excessive returns represent conclusive proof of the Bells' overwhelming market power In fully competitive markets, market forces drive prices toward costs. Costs, of

[5] These rates of return were calculated from 2001 ARMIS 43-01, Table I, Cost and Revenue Table, Column S, Rows 1910 and 1915. ***See*** Friedlander Dec. ¶¶ 2-4 & Exhibit 1 (Tab A).

course, include the "cost of obtaining debt and equity financing."[6] But in competitive markets, debt and equity investors earn – and a company can pay – only "normal" profits that compensate investors for the riskiness of the investment.[7] That is because any attempt by a firm in a competitive market to charge prices that would allow it to earn more than a normal, risk-adjusted rate-of-return would cause the firm to lose business to other firms that charged prices that reflect the lower level of return that would still be sufficient to induce investment. It is precisely for these reasons that the very definition of monopoly profit is a return in excess of normal profits.' And there can be no serious claim that the Bells must earn 50 percent rates of return to attract capital.

The ***trend*** in the Bells' excess returns for interstate special access is even more alarming. As the following chart demonstrates, the Bells' interstate special access rates of return continue to grow every year, with no exceptions, and with year-to-year increases that are quite remarkable.'



[6] *Local Competition* ***Order,*** 11 FCC Rcd. 15499,1700(1996).

[7] ***Id.***

[8] ***See*** OrdoveriWillig Dec. ¶ 23 (Tab B).

[9] ***See*** Friedlander Dec. ¶ 5 & Exhibit 1

Moreover, returns calculated from the Bells' ARMIS reports, as high as they are, grossly *understate* the extent of the Bells' special access tax on American consumers and businesses. The costs reported on the Bells' **ARMIS** reports are, of course, *embedded* costs. And, as the Commission and the courts have consistently recognized, the Bells' true costs of providing services over their local networks are their much lower forward-looking economic costs.[10] The Bells' special access rates exceed their economic costs by enormous margins.

Special access services are provided over the same facilities and are functionally equivalent to high capacity loop and transport unbundled network elements. Yet, the Bells' month-to-month special access rates are generally double or more their comparable UNE rates. The Declaration of Joseph Stith (attached hereto as Tab C) compares the Bells' tariffed interstate special access rates, on a state-by-state basis, with the rates for the functionally equivalent unbundled network elements. For services still subject to price cap regulation, the Bells' month-to-month DS1 and DS3 special access rates are routinely more than 100% higher than the comparable UNE rates, and sometimes they are even 200% or 400% higher. Thus, if the Bells' annual special access returns are calculated on the basis of their *economic* costs, rather than their embedded costs, it becomes clear that their real returns on these monopoly services are astronomical.

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[10] *See, e.g.*, *Local Competition Order* ¶ 679 ("We believe that our adoption of a forward-looking cost-based pricing methodology . . estabish[es] prices . . . based on costs similar to those incurred by the incumbents."); *Verizon Communications Inc.* v. *FCC*, 122 **S.** Ct. 1646, 1672 (2002) (costs that exceed TELRIC are inefficient costs); *Alenco Communications Co.* v. *FCC*, 201 F.3d 608, 615 (5" Cir. 2000) ("rates must be based not on *historical, booked costs*, hut rather on *forward-looking, economic costs*. After all, market prices respond to current costs; historical investments, by contrast, are sunk and thus ignored.").

In the past, the Bells have attempted to justify the disparity between their special access rates and forward-looking costs by attacking the Commission's "TELRIC" rules, claiming that since special access rates are "competitively disciplined," TELRIC must he considered the problem. In fact, it is the Bells' argument that is flawed. At the outset, it is difficult to conceive how attacking TELRIC could aid the Bells in this context, given that the Bells' special access rates are so plainly excessive even as compared to their preferred embedded cost standard. In any event, the Supreme Court has flatly rejected the Bells' criticisms of TELRIC and has upheld that established forward-looking cost estimation methodology as a fully valid and compensatory method of calculating the Bells' true costs." Indeed, TELRIC is, if anything, ***overly*** compensatory, given that costs must be calculated on the basis of existing wire center locations and given the inevitable regulatory lag in TELRIC price adjustments.'* The Bells thus have it precisely backwards: their ability to charge special access rates that are multiples of their forward-looking costs demonstrates that their special access services are *not* subject to any meaningful competitive discipline.

Any possible doubt about the Bells' pervasive market power should he put to rest by the overwhelming evidence that the Bells have, without exception, maintained or even ***raised*** their special access prices when given flexibility to do so and have had no trouble retaining customers – and, indeed, greatly ***increasing*** sales – in the wake of those price increases. Beginning in the fall of 2000, the Bells have sought and won pricing flexibility in numerous MSAs. As of the 2002 tariff filings, approximately 59 percent of the Bells' special access revenues (excluding GTE) are no longer subject to price cap regulation. In ***every*** MSA in which the Bells have

[11] *See* ***Verizon,*** 122 S. Ct. at 1672

[12] *Id.* at 1670

obtained this "Phase II" pricing flexibility, they have maintained or even ***raised*** their rates, which are now consistently above where they would otherwise be under price caps. In particular, if these services had remained subject to price cap regulation, the Bells would have been required to apply substantial X-Factor reductions to these rates in both 2001 and 2002.[13] The elimination of price cap regulation for these services has allowed the Bells to avoid those X-Factor reductions (and to keep rates at pre-pricing flexibility levels), which has deprived access purchasers of over $390 million dollars in rate reductions that they would otherwise have received since the inception of pricing flexibility.[14]

Even more egregiously, both BellSouth and Verizon have increased special access rates in every MSA in which they have been awarded Phase II pricing flexibility. For example, Verizon increased its month-to-month DS1 rates as much as 15% (and its month-to-month DS3 rates by 6%) in ***every*** MSA in which it won Phase 11 pricing flexibility, even in large cities such as New York and Boston where the presence of competitors is greatest.[15] Similarly, BellSouth raised its month-to-month DS3 rates by almost 9%, and its DS1 rates by approximately 8%, in each ***of*** the MSAs in which it received Phase II pricing flexibility, including such large cities as Atlanta and Miami.[16]

The Commission required price cap LECs to continue to file their rates in tariffs even after receiving Phase II pricing flexibility (*i.e.*, removal from price caps), and therefore it is

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[13] 47 C.F.R.§ 61.45(b)(1)(iv).

[14] ***See*** Stith Dec. ¶ 11. For example, for DSI term rates – which represent the largest volumes and the largest expense – SBC-Southwestern Bell's pricing flexibility rates are 35% higher than the price cap rates, SBC-Pacific Bell's are 24% higher, Verizon-Bell Atlantic-Souths are 16% higher, and Verizon-Bell Atlantic-North's are ***7%*** to 14% higher (depending on the state).

[15] Verizon Transmittal No. 134 (December 21, 2001).

[16] BellSouth filed Transmittal No. 608, effective November 1, 2001, increasing Special Access rates for DS3 and DSI services in MSAs with Phase II pricing flexibility.

possible to compare the Bells' tariffed Phase II rates with their price capped rates in each state. The tariffed rate in Phase II MSAs no longer subject to price cap regulation is equal to or higher than the rate for the same service in areas that remain subject to price cap regulation for virtually ***every*** special access service in ***every*** state for ***every*** Bell.[17]

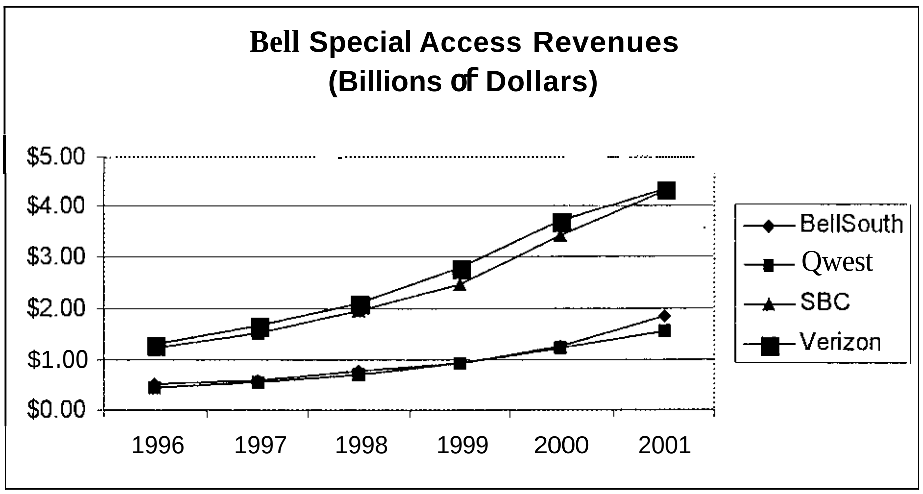
The Bells' only defense of this naked exercise of monopoly power has been to seize on the Commission's speculation in the ***Pricing Flexibility Order*** (¶ 155) that "some access rate increases may be warranted, because our rules may have required incumbent LECs to price access services below cost in certain areas." But such a claim is obviously unsustainable in light of the Bells' grossly excessive rates of return. In light of the facts, the notion that price caps were holding the Bells' rates below costs is preposterous. Indeed, even though the Bells' rates of return were ***already*** excessive when they were awarded pricing flexibility, it is striking that after most special access has now been removed from price caps, the Bells have not seen fit to respond to competition by lowering their rates in *any* of those MSAs.[18]

These rate increases are particularly anticompetitive, because the areas in which the Bells have obtained Phase II deregulation tend to be the more densely populated areas and thus would typically be characterized by costs that are ***lower*** than those in the areas in which the Bells have not received pricing flexibility. The fact that the Bells' rates are consistently higher in the lower cost areas is vivid proof that the Bells retain overwhelming market power in every local market, including those with the most competitive activity

[17] The only exception is Ameritech's rates for OC-3; the pricing flexibility rate is one percent lower than the price cap rate. The chart attached to the Stith Declaration is based on each Bell's rates as of August 1, 2002, and each price is calculated as a ten mile stand-alone circuit in order to facilitate apples-to-apples comparisons. If the distance were changed from ten miles to five miles, the pricing flexibility rate would be higher even for Ameritech's OC-3 service.

[18] ***See*** OrdoveriWillig Dec. ¶ 30

At the same time that the Bells have been increasing already above-cost access charges, IXCs and other competitive local carriers have been increasingly forced to rely on the Bells' access services, even to provide competitive local services This can he seen most directly in the dramatic increase in the Bells' special access revenues Specifically, special access revenues of the Bells have more than tripled since 1996, from **$3** 4 billion to $12 0 billion Once again, this trend holds true for all of the Bells and has been very consistent from year to year; indeed, if anything the trend has become more pronounced in recent years [19]



Of course, if last mile alternatives to the Bells' facilities truly existed, the Bells would not be able to impose staggering rate increases and simultaneously increase overall usage of their networks. Nor have carriers been able to use UNEs to bypass the Bells, as Congress intended. As AT&T has explained in detail in the Triennial UNE Review Proceeding, because of the Commission's use and commingling restrictions on enhanced extended links ("EELs"), IXCs and competitive carriers must rely on Bell special access in order to provide both exchange access

[19] ***See*** Friedlander Dec. ¶ *7* & Exhibit ***2.***

and local service." Thus, competitive entry into the local market has had the perverse effect of swelling the Bells' special access revenues (and thus their excessive earnings).

The Bells' abysmal performance in provisioning their special access services even as they continue to raise their special access rates further confirms the Bells' continuing market power and the need for immediate reform of rate regulation." The Joint Competitive Industry Group, which represents the entire spectrum of purchasers of special access (including non-carrier end-user customers), has documented the Bells' patently unacceptable performance and proposed specific performance metrics and other remedies. The fact that customers, including end-user customers, stay with the Bells in the face of both widespread service problems and excessive rates, is conclusive proof that customers rarely have alternative suppliers."

In sum, in enacting the pricing flexibility regime, the Commission recognized that pricing flexibility could be lawful only to the extent that "price cap LECs do not increase rates to unreasonable levels for customers that lack competitive alternatives."[23] But the indisputable evidence now shows that price cap LECs ***are*** increasing rates to unreasonable levels for customers that lack competitive alternatives. The Commission cannot allow this situation to continue. The Commission's prime directive is to protect the public interest by ensuring that telecommunications services are provided "at reasonable charges."[24] By any measure, the Bells'

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[20] ***See*** Comments of AT&T Corp., CC Docket No. 01-338 ***et al.***, at 136-40 (filed April 5, 2002) ("AT&T Triennial Review Comments"); Reply Comments of AT&T Corp., CC Docket No. 01-338, at 283-300 (filed July 17, 2002) ("AT&T Triennial Review Reply Comments").

[21] ***See Performance Measures and Standards for Interstate Special Access Services,*** CC Docket No. 01-321, Notice of Proposed Rulemaking (rel. Nov. 19, 2001); ***id.,*** Comments of AT&T, filed January 22, 2002.

[22] ***See*** OrdoveriWillig Dec. ¶ 31

[23] ***Pricing Flexibility Order,*** 14 FCC Rcd. 14221, ¶ 3 (1999).

[24] 47 U.S.C. § 151

special access charges exceed lawful levels by billions of dollars. Although this special access tax undoubtedly benefits the Bells, it inflicts great harm on the public and is an enormous drag on the U.S. economy

II. THE BELLS' UNLAWFUL SPECIAL ACCESS RATES ARE HAVING SEVERE AND GROWING ANTICOMPETITIVE EFFECTS.

The Bells' "creamy returns" alone require the Commission to reform its regulation of the Bells' special access rates.[25] But regulatory reform is also necessary to prevent the Bells from using their control of bottleneck network facilities to raise rivals' costs, to foreclose the development of local competition, and to impede long distance competition. Given the fragility of emerging local competition and the recent entry of the Bells into the long distance market, there is an urgent need to foreclose this anticompetitive conduct

A. The Bells' Excessive Special Access Rates Impede The Ability Of CLECs To Self-Deploy Alternative Transmission Facilities.

The Bells' bloated access charges create an enormous local entry barrier. As described in greater detail in Part III below, there are generally no alternatives to the Bells' last mile transmission facilities, even high-capacity loops and transport facilities. Thus, competitive carriers that seek to self-deploy switches are critically dependent upon incumbent transmission facilities to connect customer locations to their switches.

Competitive carriers also need access to Bell transmission facilities as a "bridge" mechanism to self-deploying their own transmission facilities in the few instances where it is theoretically economic to do so. The reasons for this are quite simple. Given the sunk cost nature of transmission facilities, competitive carriers simply cannot build transmission facilities

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[25] *Farmers Union II*, 734 F.2d at 1502-03; *Illinois Bell Tel. Co.* v. *FCC*, 988 F.2d 1254, 1260 (D.C. Cir. 1993). *See also Potomac Elec.* ***Power*** *Co.* v. *Public Utils. Comm'n of the District of Columbia*, 158 F.2d 521, 527 (D.C. Cir. 1947) *(quoting Dayton-Goose Creek R. Co.* v. *United States*, 263 U.S. 456, 483 (1924)).

"on spec" and hope that customers will show up. Rather, they need some reasonable assurance that there is sufficient demand to support a deployment of transmission facilities. *USTA* v. *FCC*, 290 F.3d 415, 424 (D.C. Cir 2002) ("access to UNEs may enable a CLEC to enter the market gradually, building a customer base up to the level where its own investment would be profitable.") Customers, on the other hand, are understandably not willing to commit to service and then wait the many months (and in some cases, years) that it takes to secure the necessary rights-of-way and build transmission facilities.[26]

The availability of UNEs could mitigate these entry barriers by allowing a CLEC to win customers immediately by purchasing access to incumbent network facilities and then to construct the transmission facilities to serve its growing customer base. In its *Supplemental Order* and *Supplemental Order Clarification*, however, the Commission permitted incumbents to impose "use" and "commingling" restrictions on combinations of unbundled loops and transport facilities that have prevented CLECs from converting special access services into unbundled network elements in all but the most unusual circumstances.[27] Thus, the only alternatives available to CLECs are the Bells' special access services. As a result, over 98% of AT&T's facilities-based *local* service for business customers using incumbent facilities of DS-1 level or higher is provided over incumbent special access services, not UNEs.[28]

Meaningful facilities-based competition is simply not possible under these conditions. As explained above, special access rates are typically twice (and sometimes three or four times) the TELRIC rates for the comparable UNEs. Because TELRIC measures the incumbent's true

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[26] *See infra* Part III.A.

[27] Comments of AT&T Corp., CC Docket No. 96-98, at 18-23 (filed April 5, 2001) ("AT&T Use Restriction Comments"); AT&T Triennial Review Reply Comments at 283-300.

[28] *See* AT&T Triennial Review Reply Comments at 283 & Pfau Reply Dec. ¶ 26 n.10.

economic costs,[29] the fact that access rates are twice TELRIC means that the CLEC's cost of accessing the underlying facilities is usually twice (or more) that of the incumbent. And a competitive carrier generally cannot justify constructing its own transport facilities unless it can aggregate traffic from numerous LSOs to a hub, and then place the aggregated traffic onto its own transport facilities at the hub.[30] CLECs are thus forced into a Hobson's Choice: they can either pay excessive special access rates to reach those additional LSOs and thereby internalize a cost structure that will not allow them to compete effectively with the Bells, or they can attempt to build fiber facilities with enormous excess capacity and substantial up front costs that would dwarf the reasonably anticipated revenue stream. In either case, these costs – which the Bells do not face – are true barriers to entry that simply foreclose broader facilities-based competition.

B. Existing Regulation Permits The **Bells** To Target Their Market Power.

The competitive damage permitted under the existing rules goes well beyond allowing the Bells to charge excessive prices for critical inputs that serve as a necessary bridge or complement to facilities deployment. The Bells' ability to engage in discriminatory contract tariffs is equally pernicious, because it allows the Bells surgically to foreclose competition. In particular, the existing pricing flexibility rules permit the Bells to price discriminate in order to prevent entry or drive competitors out of the market and to use long term contracts to deny competitors access to the traffic necessary to justify facilities deployment.

The Existing Regulations Permit The Bells To Engage In Exclusionary Pricing Behavior. It has been noted that the Bells' grossly excessive special access rates create a "price umbrella"

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[29] *Local Competition Order* ¶ *619*

[30] *See* AT&T Triennial Review Reply Comments at 251-52

for CLECs that deploy alternative facilities. However, as Professor Willig has explained, the sunk cost nature of investment in transmission facilities means that

> reliance on the existence of this pricing umbrella . . . is very risky. To the extent that an ILEC can price discriminate, it will he able to lower prices selectively, only to those customers that could potentially be served by the new entrant and keep prices high for all other customers. For example, if a competitive carrier were to deploy transport facilities between two points, an ILEC could respond by lowering prices on that route but not any others. Also, the price umbrella could be collapsed by the possible future entry of ***other*** CLECs. Thus, even if a CLEC can be reasonably sure that prices will remain stable in the near term after entry, to be successful over the long term, it must enter at costs comparable to the ILEC's because there remains a significant risk that the ILEC will ultimately choose to lower its prices down towards its costs.[31]

The Commission in its ***Pricing Flexibility Order*** (¶ 79) was "concerned" about this precise point. The Commission observed that "Phase I relief, which enables [the Bells] to offer contract tariffs to individual customers, [could permit the Bells] to engage in exclusionary pricing behavior." *Id.* In particular, the Commission observed that, absent regulation, the Bells had the ability to "reduce prices in the short run and forgo current profits in order to prevent the entry of rivals or to drive them from the market." *Id* Indeed, because the Bell almost always enjoys substantial advantages over the CLEC in terms of per-unit costs, the Bell can reduce its rates to a point between its own unit cost and that of the CLEC at any time. As a result, the Bell can drive any CLEC from the market to the extent the CLEC's business plan is based on being able to charge prevailing supracompetitive access prices.[32]

The Commission found that these concerns would be addressed by its decision to grant downward pricing flexibility only where CLECs had made "substantial sunk investment." *Id* ¶ 80. The Commission reasoned that where investment in alternative facilities had been sunk, the

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[31] AT&T Triennial Review Reply Comments, Willig Reply Dec. ¶ 25

[32] ***See*** AT&T Triennial Review Reply Comments, Lesher Reply Dec. ¶ 28

Bells would have no incentive to engage in exclusionary behavior because there would be little prospect of driving the CLECs out of the market. "If a competitive LEC has made a substantial sunk investment in equipment, that equipment remains available and capable of providing service in competition with the incumbent, even if the incumbent succeeds in driving that competitor from the market." *Id.*

Experience now shows that the Commission's belief that its pricing flexibility triggers "measure the extent to which competitors have made sunk investment in facilities used to compete with the incumbent LEC' was erroneous. For example, the trigger for deregulation of dedicated transport is inherently flawed, because it focuses only on whether there is *some* fiber deployed in a collocation, and not whether the CLEC's transport facilities fully bypass the Bell's transport facilities. Indeed, as the Commission itself noted in the *Pricing Flexibility Order* (¶ 81), most transmission facilities in a collocation are trunk-side "facilities leading from the collocated equipment to the IXC POP." As a result, the Commission's dedicated transport trigger deregulates the Bell's transport rates, even though the CLEC has bypassed only one of the transport links included in that service – the Bell's entrance facilities. The triggers for channel terminations are even less representative of the existence of relevant sunk investment, because they rely exclusively on a showing of *transport* deployment as evidence of loop deployment.[33] Under this test, a Bell can receive deregulation of its channel termination rates without showing that CLECs have deployed a single loop anywhere in the **MSA.** In other words, the collocation trigger identifies only the possibility of competitive facilities between the collocation cage and

[33] This is rather like deregulating the rates for first class mail because there is competition for overnight deliveries under the "trigger" that post offices are used in the delivery of both overnight mail packages and first class mail. In effect, the existing special access pricing flexibility triggers allow deregulation of "first class mail" (here, transport and customer channel terminations) because there is competition for "overnight packages" (entrance facilities) through

the competitor; it says nothing about the potential for competition between the collocation cage and the customer – *i.e.*, interoffice transport and loop equivalent facilities.[34]

The Commission's "percentage of revenues" trigger is especially pernicious. The Commission offered the Bells two alternative triggers: they could demonstrate "fiber-based collocations" in a certain percentage of the wire centers in an MSA, ***or*** they could show fiber-based collocations in wire centers representing a certain percentage of the Bell's revenues from the relevant services in that **MSA.** The "percentage of revenues" test usually means that the Bell need only demonstrate facilities-based collocations in an even smaller percentage of wire centers **(*i.e.***, those in the most urban area of the **MSA),** and – not surprisingly – the Bells have relied almost exclusively on that alternative trigger in winning pricing flexibility all over the country

The ***Existing Rules Permit*** *The* ***Bells*** *To* ***Engage*** *In* ***Customer Foreclosure.*** **As** the Commission recognized in its ***Pricing Flexibility Order,*** the Bells can prevent facilities competition by engaging in customer foreclosure. In particular,

> [a]n incumbent can forestall the entry of potential competitors by "locking up" large customers . . . . Specifically, large customers may create the inducement for potential competitors to invest in sunk facilities . . . . To the extent the incumbent can lock in the larger . . . customers whose traffic would economically justify the construction of new facilities, the incumbents can foreclose competition for the smaller customer as well.[35]

It is now clear that the existing rules do not prevent this type of exclusionary conduct. The Bells are using their market power to force carriers to enter into anticompetitive optional pricing plans ("OPPs") that remove even the possibility that market forces could constrain the

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the use of the collocation cages (post offices).

[34] This is especially problematic because entrance facilities represent a relatively small percentage of the overall cost of special access (typically around 15 percent).

[35] ***Pricing Flexibility Order*** ¶ 79.

Bells' market power. The Bells have threatened IXCs with even higher rates unless they sign long-term contracts with huge penalties for early termination. Carriers have agreed to these OPP deals, because of the urgent need to cut access expense (or, at least, to keep it from rising even further)

These OPPs are severely anticompetitive. For example, virtually all of these plans require AT&T to commit to certain levels of annual purchases to obtain the discounts. As a result, if AT&T were to migrate even a relatively small portion of its traffic to its own or Bell competitors' facilities, it would lose the OPP discounts (typically on a ***regionwide*** basis), which in most cases would dwarf whatever savings AT&T could achieve by using competitive alternatives. Indeed, some Bells have insisted on specific penalties for migrating traffic to competitors.[36] And even if more broadly available alternatives were to become available – *e.g.*, if the Commission were to eliminate use restrictions on EELs or if broad-based facilities-based alternatives were somehow to emerge – AT&T could not take advantage of them in many cases, because virtually all of these OPP plans impose substantial penalties for early withdrawal, which would negate any savings.[37] Moreover, as the Commission recognized in the ***Pricing Flexibility Order,*** long term contracts can also prevent entry because the Bells have locked up the largest

[36] For example, SBC's Managed Value Plans require that, to the extent AT&T meets its special access needs over SBC facilities (as it overwhelmingly must), it must use UNEs to provision no more than 5% of those needs, and it must meet 95% or more of those needs using SBC special access Similarly, Qwest's plans require AT&T to pay 125% of the remaining value of the OPP for circuits that are converted to UNEs. And Verizon's plans condition discounts for DS1 services on expanded commitments to purchase **DS3** services.

[37] For example, SBC's Managed Value Plans require forfeiture of the previous six months' credits plus anywhere from 20% to 40% of the monthly revenue commitment for the remainder of the term of the agreement. Qwest imposes termination penalties of 100% of the recurring expense for the first remaining year plus 50% of the recurring expense for all other remaining years.

special access customers, thereby depriving competitive carriers of the traffic and revenues necessary to fund construction of bypass facilities [38]

C. The Bells' Excessive Special Access Rates Are Having An Increasingly Anticnmpetitive Impact **On** The **Long** Distance Market.

The Bells' excessive special access rates also are having an increasingly anticompetitive effect in the long distance market, as the Bells win interLATA authority. Access is a "necessary input for long-distance service" and access charges constitute a sizeable percentage of the overall cost of long distance services [39] This gives the Bells the opportunity to undertake a classic strategy ofraising rivals' costs.[40]

> Absent appropriate regulation, an incumbent LEC and its interexchange affiliate could potentially implement a price squeeze once the incumbent LEC began offering in-region, interexchange toll services. . . . The incumbent LEC could do this by raising the price of interstate access services to all interexchange carriers, which would cause competing in-region carriers to either raise their retail rates to maintain their profit margins or to attempt to maintain their market share by not raising their prices to reflect the increase in access charges, thereby reducing their profit margins. If the competing in-region, interexchange providers raised their prices to recover the increased access charges, the incumbent LEC's interexchange affiliate could seek to expand its market share by not matching the price increase. The incumbent LEC affiliate could also set its in-region, interexchange prices at or below its access prices. Its competitors would then be faced with the choice of lowering their retail rates for interexchange services, thereby reducing their profit margins, or maintaining their retail rates at the higher price and risk losing market share.[41]

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[38] The Commission has previously ordered the Bells not to apply termination penalties in similar circumstances. *See Local Exchange Carriers' Individual Case Basis DS3 Service Offerings,* CC Docket No. *88-136,* 4 FCC Rcd. *8634,* ¶ *79 (1989)* (in ordering LECs to convert all individual case basis pricing for DS3 services to generally available rates, the Commission found that "we will not permit LECs to assess converted ICB customers termination liability charges or non-recurring charges").

[39] *Access Reform Order,* 12 FCC Rcd. 15982, ¶ 275 (1997).

[40] *See generally Premier Elec. Constr. Co.* v. *National Elec. Contractors Ass'n,* 814 F.2d *358, 368* (7th Cir. *1987)* (citing T. Krattenmaker & S. Salop, *Anticompetitive Exclusion; Raising Rivals' Costs to Achieve Power over Price, 96* Yale L.J. *209* (1*986)).*

[41] *Access Reform Order* ¶ 277

The Commission's *Access Reform Order* made the predictive judgment that "appropriate regulation" was in place to prevent such anticompetitive price squeezes. But in so holding, the Commission relied on both the existence of price cap regulation to "limit[] the ability of LECs to raise the prices of the input services,"[42] and the availability of UNEs that would allow "rival long-distance providers" to "purchase unbundled network elements" as substitutes for Bell-provided access.[43] The *Pricing Flexibility Order* gutted the "limit" imposed by the price cap regime, and the *Supplemental Order* and *Supplemental Order Clarification* foreclosed IXCs from using UNEs for access.

The evidence confirms that the Bells not only can but have undertaken such price squeezes. For example, BellSouth offers an intrastate service in its region called "Fast Packet Option." Under this offer, end users can obtain special access at rates that are lower than those in BellSouth's federal tariffs, but only if the end user agrees to purchase BellSouth's frame relay services as well.[44] As a result, AT&T cannot obtain special access at the "Fast Packet Option" rates and pair that service with its own frame relay services. The Bells' grossly excessive special access rates easily facilitate such blatant price squeezes, and the dangers of such price squeezes will only increase as the Bells' continue to win interLATA authority under Section 271.[45]

[42] *Id.* ¶ 276.

[43] *Id.* ¶ 280; *see also Bell Atlantic NYNEX Merger Order,* 12 FCC Rcd. 19985, ¶ 117 (1997).

[44] *Compare* BellSouth Telecommunications Inc., Georgia, General Subscriber Service Tariff, Twelfth Revised Page 1, A.40 (Frame Relay Service), *with* BellSouth Telecommunications, Inc., Tariff FCC No. 1, 6th Revised page 21-1 (Fast Packet Access Services). BellSouth has similar tariffs in each of the states in its region.

[45] *See* OrdoveriWillig Dec. ¶¶ 62-67