

BEFORE THE
Federal Communications Commission
WASHINGTON, D.C.

In the Matter of)
)
AT&T's Petition for Rulemaking to Reform) RM No. 10593
Regulation of Incumbent Local Exchange)
Carrier Rates for Interstate Special Access)
Services)

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 Public Notice¹ in the above-referenced proceeding.

I. INTRODUCTION AND SUMMARY

As AT&T demonstrates in its Petition,² the ILECs continue to have substantial and persisting market power in the special access market. It should be obvious that facilities-based competitors like TWTC do not have large enough networks or broad enough service offerings to force the ILECs to reduce prices broadly. AT&T is correct that this fact should cause the Commission to reassess the extent to which ILECs retain the ability to unilaterally raise prices in areas where they do not face significant competition. But AT&T's Petition does not fully address the equally important need to establish a regulatory regime that allows competition in the

¹ See *Wireline Competition Bureau Seeks Comment on AT&T's Petition For Rulemaking To Reform Regulation Of Incumbent Local Exchange Carrier Rates For Interstate Special Access Services*, Public Notice, DA 02-2913 (rel. Oct. 29, 2002).

² See AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services, RM No. 10593 (filed Oct. 15, 2002) ("AT&T Petition").

provision of special access to continue to develop. This is of course the most effective way for the Commission to ensure that regulation can be eliminated in the future.

In particular, by granting the ILECs the freedom to selectively drop prices for individual customers, the Commission has given the ILECs the opportunity to protect their high rates of return by engaging in predatory pricing. That is, ILECs can meet the limited facilities-based competitive entry that exists today with steep, targeted price reductions without jeopardizing their overall high rates of return. As recent scholarly work has confirmed, such predation is much more profitable and likely than has sometimes been assumed in the past. Moreover, the ILECs remain free to raise their rivals' costs through non-price discrimination in the absence of comprehensive performance measurements, reporting requirements, and penalties.

Accordingly, the Commission should, indeed must, initiate a proceeding to reconsider the pricing flexibility regime. In addition, as an indispensable complement to re-imposing price caps on special access services and eliminating contract tariffs, the Commission must adopt effective performance measurements, standards, and penalties to deter abuse of ILEC market power over inputs to competitive providers of special access. Finally, the Commission should deny AT&T's interim relief proposal to re-impose what is effectively rate-of-return regulation on ILEC special access services. Instead, the Commission should act quickly to initiate and complete a rulemaking to establish a sound long-term solution.

II. THE COMMISSION SHOULD PROMPTLY INITIATE A RULEMAKING TO REPEAL THE PRICING FLEXIBILITY REGULATIONS AND TO RE-IMPOSE PRICE CAPS ON ILEC SPECIAL ACCESS SERVICES.

Deregulation of ILEC special access services has gone too far, too fast. The available ARMIS data tracking activity since pricing flexibility was implemented demonstrates that ILECs still have market power. Moreover, because of the freedom to enter into individually negotiated

contract tariffs and the elimination of price cap regulation granted in Phases I and II respectively, the ILECs have many more opportunities to exercise their market power than would be the case in the absence of such relief. As a result, ILECs granted pricing flexibility are able to exercise their market power over pricing and to deter expansion and future entry by competitors to the detriment of competition in the special access market and the broader telecommunications market. Accordingly, the Commission should promptly grant the AT&T Petition to initiate a rulemaking to repeal the pricing flexibility regulations and to re-impose price caps on ILEC special access services. Equally important, the Commission should limit ILEC opportunities to engage in non-price discrimination by adopting effective performance measurements, standards, and penalties for ILEC provisioning of special access services.

A. The Commission should repeal pricing flexibility and re-impose price caps to effectively limit ILEC abuses of market power over pricing.

Monopoly Profits. The ARMIS data presented in the AT&T Petition is striking. The data shows that ILECs continue to exercise market power by raising rates in markets where they have been granted pricing flexibility, achieving rates of return well above those that would be expected in a competitive market. Since gaining Phase II pricing flexibility in markets that account for approximately 59 percent of the BOCs' special access revenues, BOCs have maintained or even increased prices, while at the same time advancing the illogical claim that they face intense competition from new entrants. *See* AT&T Petition at 12. Even in major cities with the most facilities-based competition, such as New York and Boston, BOCs have been able to raise rates -- something they would be unable to do without market power. *See id.* It is obvious that the facilities-based alternatives to ILEC special access are far too limited in scope to

cause ILECs to reduce special access prices to a significant percentage of the market. As a result, the BOCs' 2001 special access rates of return were all above 20 percent. *See id.* at 8.

Furthermore, it appears that ILEC market power is not only unconstrained by competition, but is also unconstrained by customer price elasticities of demand. As AT&T points out, despite what appear to be fairly high rates of return, overall usage of ILEC special access services continues to increase. *See AT&T Petition* at 14.

In sum, the competition that the Commission predicted would protect special access customers (both end users and carriers that also compete with the ILECs) from the exercise of market power over pricing has not materialized in the years following the adoption of pricing flexibility. Of course, price caps remain the most efficient and effective method of restraining the ILECs' ability to raise prices unilaterally. Faced with the ARMIS data described by AT&T, the Commission has no lawful choice but to initiate a rulemaking to re-examine its pricing flexibility regime.³

Predatory Pricing. To be sure, ILECs do face competition in some geographic areas from facilities-based providers of special access such as TWTC. But those competitors have only been able to compete in small geographic areas and only for customers in certain buildings. The problem with the current regulatory regime is that it does not even attempt to constrain

³ *See, e.g., Texas Off. of Pub. Util. Counsel v. FCC*, 265 F.3d 313, 325 (5th Cir. 2001) ("If, in light of actual market developments, the Commission determines that competition is not having the anticipated effect on access charges, the agency presumably will revisit the issue."); *CELLNET v. FCC*, 149 F.3d 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 now "settled law that an agency may be forced to reexamine its approach 'if a significant factual predicate of a prior decision ... has been removed.'" (citations omitted)).

ILECs from engaging in anticompetitive behavior that significantly constrains the growth of the limited competition that exists now. Most obviously, premature pricing flexibility allows ILECs to drop prices selectively and aggressively in a manner that reduces the likelihood that existing competitors will expand entry to other geographic markets and that new competitors will enter in the future. Moreover, such price reductions can be targeted narrowly, so that they do not jeopardize the ILECs' overall high rates of return. The result is a form of predatory pricing that is much more sophisticated, profitable, and likely than the ILECs would like the Commission to believe. As TWTC argued before the Commission adopted its pricing flexibility rules,⁴ price caps, and in particular a prohibition on contract tariffs, are needed to protect competition from this type of anticompetitive conduct.

It has sometimes been assumed that predatory pricing as traditionally understood (*i.e.*, dropping prices to drive competitors out of the market so that the dominant firm can subsequently raise prices above competitive levels and recoup losses experienced during the low-price period) is rarely tried and even more rarely successful. But over the past 20 years, economists have come to understand that this characterization of predation is inaccurate. Modern economists have come to a general consensus that "predatory pricing can be a successful and fully rational business strategy," especially when the market structure facilitates predation,

⁴ See Time Warner Telecom Comments, CC Docket Nos. 96-262, 94-1, 97-250, RM-9210 at 14-19 (filed Oct. 26, 1998).

characterized by a dominant firm with high market share and substantial entry and reentry barriers (most importantly in the form of sunk costs).⁵

Specifically, past characterizations of predation often assumed that predatory pricing schemes involve predatory losses across entire markets or large segments of markets with the need to recoup those losses through monopoly profits and also assumed that the prey had full knowledge of the predator's costs. In these circumstances, predatory pricing is "rarely tried, and even more rarely successful,"⁶ because the price reduction is very costly to the predator and the prey knows that it need only wait out the price reduction because it is unsustainable if below the predator's costs. But economists now understand that predatory pricing strategies are much more likely to be tried and much more likely to be successful where the predator can carefully discriminate in pricing and where the prey does not know the predator's costs.⁷ In pursuing a so-called "cost signaling" strategy,

⁵ Patrick Bolton et al., *Predatory Pricing: Strategic Theory and Legal Policy*, 88 Geo. L.J. 2239, 2241, 2264-65 (2000) ("*Bolton*"). Bolton et al. describe predatory pricing as follows:

Predatory pricing is defined in economic terms as a price reduction that is profitable only because of the added market power the predator gains from eliminating, disciplining, or otherwise inhibiting the competitive conduct of a rival or potential rival. Stated more precisely, a predatory price is a price that is profit-maximizing only because of its exclusionary or other anticompetitive effects. The anticompetitive effects of predatory pricing are higher prices and reduced output--including reduced innovation--achieved through the exclusion of a rival or potential rival.

Bolton at 2242-43 (citations omitted); see also F.M. Scherer, *Industrial Market Structure and Economic Performance* 335-36 (2d ed. 1980). Limit pricing is a type of predatory pricing in which the goal of the pricing strategy is to deter entry rather than to drive out existing competitors. See *id.* at 232-36.

⁶ *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574, 589 (1986).

⁷ See *Bolton* at 2318-20; see also Paul Milgrom and John Roberts, *Industrial Structure in the New Industrial Economics* 124-29 (1990) ("*Milgrom & Roberts*").

a predator drastically reduces price to mislead the prey into believing that the predator has lower costs, inducing the prey to exit the market. More specifically, a predator trying to establish a reputation for low cost cuts its price below the short-run, profit-maximizing level. Observing the predator's low price, the prey rationally believes there is at least some probability that the predator has reduced costs. This lowers the prey's expected return and causes the prey to exit.

Bolton at 2318. That is, a firm, that has not actually achieved a cost advantage, can engage in a predatory strategy to mislead the second firm -- a firm with imperfect information -- into believing that it has achieved much lower costs. *See id.* In a cost signaling strategy, the dominant firm reduces its price to what it would charge if it actually had achieved a cost-reducing breakthrough. *See id.* Because the prey has imperfect knowledge, it has no way of knowing whether the "cost reduction" is legitimate or whether the predator is bluffing. *See id.* "Instead, the intended victim must make a probability assessment, based on available information, to determine whether its expected return from staying in the market exceeds its expected return from leaving--and investing its capital elsewhere." *Id.* Economists conclude that this strategy can be successful because competitors' investment decisions are likely to be strongly influenced by the predator's pricing even if they suspect but they cannot be certain that the predator is bluffing. *See Bolton* at 2318-19. Moreover, it is critical to emphasize that the competitor need not fully exit the market, but only reduce output, for the pricing strategy to be successful. *See Milgrom & Roberts* at 125.

The special access market is particularly vulnerable to this type of predatory pricing. As mentioned, competitive entry continues to be restricted to small geographic areas. Moreover, the special access market is characterized not only by high entry/re-entry barriers (again, especially very high sunk costs), but also by extreme information asymmetries, which set the stage for cost signaling predation. ILECs enjoy an

overwhelming informational advantage about the true economic costs of operating their special access networks. This is especially true since special access service is provided over the same facilities as many other services, making any assessment of “cost” ultimately a function of the ILEC’s own internal (largely arbitrary) judgments. Moreover, pricing flexibility allows ILECs to strategically lower prices in a targeted manner (through contract tariffs) to send pricing signals to competitors. This is especially effective in the special access market because sales are “lumpy,” and a small number of customers often represents a disproportionate percentage of overall demand. One selective price decrease therefore sends a strong signal to competitors. Because cost information is not available to competitors, competitors and potential competitors must try to make educated guesses based on ILEC prices and other information market information. Even if the competitor suspects that the ILEC is engaged in cost signaling, it may choose to exit the market for one with more certain market conditions or to reduce its own output.

Moreover, the incumbent that engages in predatory pricing may benefit from so-called “reputation effect” predation as well. *See Bolton* at 2300-01. Predators can achieve a reputation for aggressive conduct in one market that leads potential entrants to believe that the predator will price just as aggressively against new entrants in the future, developing a reputation that acts as a barrier to entry in other markets or in the same market in a future time period for future entrants. *See id.* Given that competitors are unlikely to completely exit the market because their costs are sunk and facilities remain in place, reputation effect predation is especially likely in the special access market.

Indeed, anticompetitive activity is even more beneficial to ILECs with large service areas, for example SBC and Verizon. As the Commission has recognized, the larger an ILEC's network footprint, the greater its incentive is to engage in anticompetitive behavior.⁸ 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 engages in predatory pricing of its special access services in one part of its service territory, a competitor may be disinclined to enter wherever the ILEC has pricing flexibility. The larger the ILEC's territory, the greater the benefit the ILEC gains from the CLEC's decision not to compete.

The Commission itself has repeatedly recognized the seriousness of the ILECs' incentives to engage in predation. As the Commission explained,

Economists have long noted the incentives that monopolists have 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. The monopolist then would be able to raise prices above competitive levels and earn higher profits than would have been possible if the exclusionary pricing behavior had not occurred and competitors had not exited or been deterred from entering the market. Joskow and Klevorick note the conditions that increase the likelihood, and the social cost, of exclusionary pricing behavior. Several of these conditions, including short-run monopoly

⁸ 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, ¶ 60 (1999) ("*SBC/Ameritech Order*") (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."), *vacated on other grounds*, *Ass'n of Communications Enterprises v. FCC*, 235 F.3d 662 (D.C. Cir. 2001); *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).

power, low elasticity of demand, and high profits in the absence of regulatory or competitive constraints, appear to characterize the interstate access market.⁹ Based on this understanding, the Commission denied ILECs pricing flexibility in the provision of special access before the pricing flexibility regime was established in order to prevent predation. For example, in reviewing a Southwestern Bell pre-pricing flexibility tariff transmittal, the Commission concluded that the incumbent would be able to engage in predatory behavior if the tariff revisions (which would have given Southwestern Bell the freedom to respond to RFPs with special price offerings tailored to the RFP) became effective. The Commission reasoned that,

[b]ased on this record, we are concerned that Transmittal 2633 may permit SWBT unreasonably to deter or foreclose competitive entry into the markets in which it has a monopoly. As formulated, Transmittal 2633 allows SWBT a virtually unlimited opportunity to preempt new market entrants in its territory by reducing rates to individual customers to which it believes new entrants may make offers, without making those rates available to similarly situated customers elsewhere. The threat of such market foreclosure is inconsistent with our ultimate goal -- competition for the provision of access service and the deregulation of incumbent LEC access services.¹⁰

Moreover, the Commission explained that,

SWBT may find it advantageous to offer lower prices to a few relatively large access customers even when such reductions might not, in the short term, contribute as much to profits as would a generally available tariffed rate. *** In this situation, SWBT would not have to price its service below its incremental

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, ¶ 79 (1999) (“*Pricing Flexibility Order*”), *aff’d*, *WorldCom, Inc. v. FCC*, 238 F.3d 449 (D.C. Cir. 2001) (citations omitted) (citing Paul L. Joskow & Alvin K. Klevorick, *A Framework for Analyzing Predatory Pricing Policy*, 89 Yale L.J. 213 (1979)).

¹⁰ *Southwestern Bell Tel. Co., Tariff F.C.C. No. 73*, Order Concluding Investigation and Denying Application for Review, 12 FCC Rcd 19311, ¶ 42 (1997).

cost. When new entrants have not reached a level of output where they benefit from economies of scale, their incremental costs are greater than the incumbent's.¹¹

In addition, the Commission has very recently acknowledged that “targeted pricing discounts by an established incumbent with dominant market power may be used to eliminate nascent competitors and stifle competitive entry.”¹²

Moreover, the Commission originally designed the price cap regime expressly to limit ILEC incentives to engage in predation.¹³ By setting price cap ceilings for baskets above which the aggregate prices are not allowed to rise, the price cap regime makes it “difficult for [ILECs] to engage in the classic predation scenario of lowering prices to predatory levels today in an effort to raise them to monopoly levels once competition is defeated.”¹⁴

But in 1999, in the Commission’s zeal to replace regulation with competition, it dealt a severe blow to the price cap regime and its ability to control predatory pricing by adopting the *Pricing Flexibility Order*. At that time, the Commission acknowledged that if pricing flexibility

¹¹ *Id.* ¶ 49, n.120 (citing Eric B. Rasmusen et al., *Naked Exclusion*, 81 American Economic Review 1137, 1137-45 (1991)).

¹² *Applications for Consent to the Transfer of Control of Licenses from Comcast Corporation and AT&T Corp., Transferors, to AT&T Comcast Corporations, Transferee*, Memorandum Opinion & Order, FCC 02-310, ¶ 120 (rel. Nov. 14, 2002).

¹³ *See Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, 5 FCC Rcd 6786, ¶¶ 36, 226 (1990) (“*ILEC Price Cap Order*”).

¹⁴ *Id.* ¶ 36. The Commission also initially set lower price bands to deter predatory pricing, but later eliminated this regulation, finding that the PCI and upper pricing bands would adequately control predatory pricing. *See id.* ¶ 226; *Access Charge Reform; Price Cap Performance Review For Local Exchange Carriers; Transport Rate Structure and Pricing; Usage of the Public Switched Network by Information Service and Internet Access Providers*, Notice of Proposed Rulemaking, Third Report & Order, and Notice of Inquiry, 11 FCC Rcd 21354, ¶ 305 (1996).

were granted prematurely, it “might enable price cap LECs to ... exclude new entrants from their markets....” *Id.* ¶ 68. The Commission expressed concern that Phase I relief (*i.e.*, contract tariffs) could allow ILECs “to engage in exclusionary pricing behavior and thereby thwart the development of competition.” *Id.* ¶ 79. The Commission emphasized that “pricing flexibility must be structured to prevent exclusionary pricing behavior so as to safeguard the development of competition,” while acknowledging that granting pricing flexibility on an MSA-basis without competitive facilities in every wire center in the MSA could allow ILECs to “use pricing flexibility in a predatory manner to deter investment in competitive facilities in those wire centers where [they] as yet face[] no competition.” *Id.* ¶¶ 79, 83. Based on “predictive forecasts,” the Commission set -- and the D.C. Circuit upheld -- pricing flexibility triggers designed to ensure that there is ample competition to allow regulatory relief without subjecting competition to the risks of predatory pricing schemes by the incumbents. *See WorldCom v. FCC*, 238 F.3d at 459.

But no matter how reasonable it seemed at the time, the prediction upon which the Commission relied to set the pricing flexibility triggers has proven to allow premature pricing flexibility for special access services. As discussed, ILECs have exploited their market power over pricing by raising prices and extracting what the ARMIS data indicates are high rates of return. Moreover, the removal of price cap protections in the face of this market power results in a substantial on-going risk of predatory pricing by incumbents to drive out or deter entry by competitors. As a result, it is time for a thorough re-examination of the pricing flexibility regime for special access services and the assumptions on which it is based.

Nor is this just theory. Although there has been no investigation into possible ILEC predatory pricing in the special access market, recent evidence suggests that the ILECs have begun to selectively drop prices to discipline competitors. For example, WorldCom recently submitted a detailed analysis of special access pricing in the *Triennial Review* proceeding. While that study showed that “BOCs have willfully gouged special access customers on the rate element that is least addressable by competitive providers,” (that is, mileage charges), it is equally noteworthy that the study found that the fixed special access charge for DS-3s (presumably the element of special access services for which ILECs would face the most competition) is on average lower than the fixed UNE charge for the same facilities.¹⁵ While the expected ILEC response would be that they are merely responding to competition as the Act and the Commission intended, it is nonetheless a particularly worrisome turn of events given that the ILECs have consistently argued that UNE pricing is below cost.¹⁶ If indeed some UNE prices are below cost as they contend, then they have priced certain special access elements subject to competition below cost. In any event, this practice could be an early indication that the ILECs have begun to engage in predatory pricing in areas where they face competition. At a minimum,

¹⁵ See *Ex Parte* Letter to Marlene H. Dortch, FCC, from Ruth Milkman, Counsel to WorldCom, CC Docket Nos. 01-338, 96-98, 98-147 at 6, 7 (filed Oct. 30, 2002). This analysis appears to be based on the conclusion that ILECs have greater market power for circuits of greater length. This makes intuitive sense, because competitors like TWTC have only been able to construct networks in narrowly-defined, densely populated urban areas where circuits are relatively short.

¹⁶ See, e.g., Petitioner’s Brief at 14, *Verizon Communications v. FCC*, 122 S.Ct. 1646 (2002) (Nos. 00-511 *et al.*) (“The losses imposed by TELRIC pricing for those UNEs are massive.”); *id.* at 18 (“TELRIC is a final rule that systematically undercompensates incumbents.”); *id.* at 31 (“The FCC cannot deny that TELRIC prices are half the historical costs of UNEs and therefore require incumbents to operate the entire wholesale enterprise at a substantial loss.”).

the potential for predatory pricing in the special access market deserves full investigation as part of a rulemaking to reconsider pricing flexibility and the continuing need for the price cap regime.

B. The Commission should also act to limit ILEC abuses of market power over inputs.

While the Commission must assess the extent to which the existing pricing flexibility regime allows ILECs to exercise market power, it must also focus on the extent to which other aspects of the regulatory regime applicable to special access have left ILECs free to harm competition and consumer welfare. For even if the Commission eliminates (as it should) ILEC opportunities to engage in price discrimination, the ILECs would be free to engage in non-price discrimination.

Competitive providers of special access like TWTC are often unable to construct their own end-user connections. This is the case where, for example, TWTC is unable to obtain building access on reasonable terms and conditions, or where an end-user location is too far from the TWTC network to justify construction, where the end user needs service turned up more quickly than TWTC can construct facilities. As a result of these and other factors, TWTC often must buy ILEC end-user special access connections as an input to its own special access offering. As explained, ILECs remain the dominant, in many cases the only, providers 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).¹⁷ By raising their rivals' costs,

¹⁷ See *Review of Regulatory Requirements for Incumbent LEC Broadband Telecommunications Services*, Notice of Proposed Rulemaking, 16 FCC Rcd 22745, ¶ 29 (2001) (“an incumbent LEC might improperly exercise its existing market power through cross-subsidization, raising rivals costs, or improper discrimination.”) (citations omitted); *The Merger of MCI Communications Corp. and British Telecommunications plc*, Memorandum Opinion Order, 12 FCC Rcd 15351, ¶ 158-61 (1997) (“[I]f ... the quality of the input and other terms of its provisioning are

dominant firms, like the ILECs in the special access market, can keep prices well above cost without losing market share. This can be achieved by providing the competitor with poor and discriminatory service quality.

ILECs have strong incentives to act in this way. Rather than viewing special access purchasers as “customers,” ILECs now view CLECs and IXCs as existing and/or potential competitors for special access, local, and interexchange revenues.¹⁸ These incentives to degrade the quality of special access services to competitors are only magnified as the BOCs gain approval to enter the in-region interLATA market in more states.¹⁹ Indeed, these incentives are especially strong for ILECs with large service areas -- such as SBC and Verizon -- because (as mentioned) the larger the ILEC’s territory, the greater the benefits of anticompetitive conduct. *See SBC/Ameritech Order* ¶ 60; *Bell Atlantic/GTE Order* ¶ 96. Thus, the ILECs’ already substantial incentives to discriminate in the provision of special access are increasing. Until facilities-based competitors are able to offer a meaningful alternative to the ILECs’ special access end-user connections, it is critical that effective performance measurements be adopted and meaningful enforcement be applied to deter ILECs from acting on these anticompetitive

well-monitored, then the firm may be unable to raise its rivals’ costs [through non-price methods.]”). *See generally* Steven C. Salop and David D. Scheffman, *Raising Rivals’ Costs*, 73 *Recent Advances in the Theory of Industrial Structure* 267 (1983) (“Some nonprice predatory conduct can best be understood as action that raises competitors’ costs. To a predator, raising rivals’ costs has obvious advantages over predatory pricing. It is better to compete against high-cost firms than low-cost ones. Thus, raising rivals’ costs can be profitable even if the rival does not exit from the market.”).

¹⁸ *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).

¹⁹ *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 (2000).

incentives. Thus, in addition to repealing pricing flexibility, the Commission must adopt performance measurements. Together, these reforms will deter ILECs from acting on their incentives and opportunities to engage in price and non-price anticompetitive conduct through their market power over special access services.

III. THE COMMISSION SHOULD DENY AT&T'S INTERIM RELIEF PROPOSAL TO RE-IMPOSE RATE-OF-RETURN REGULATION ON ILEC SPECIAL ACCESS SERVICES.

While the Commission should suspend all pricing flexibility proceedings until a rulemaking proceeding is completed, it should deny AT&T's interim relief proposal to "reduce all special access charges for services subject to Phase II pricing flexibility to the rates that would produce an 11.25% rate of return..." AT&T Petition at 39. This proposal is bad policy and in any event unnecessary. Rather than "retargeting" rates as AT&T suggests, it would be more efficient for the Commission to quickly complete a rulemaking to adopt a long-term solution by repealing pricing flexibility and re-imposing price caps. After reinitializing price caps at the level that would have applied had price cap regulation never been eliminated, the Commission should allow price caps to apply going forward without constantly readjusting the rate of return.

AT&T's proposal is simply the most recent of many requests to readjust price cap rates to achieve a desired rate of return. Yet when repeatedly readjusted in this manner price caps

effectively function as rate-of-return regulation, negating the benefits of the price cap regime and re-imposing the costs of rate-of-return regulation.²⁰

The Commission has long recognized the substantial costs associated with rate-of-return regulation. First, “[r]ate-of-return regulation lacks incentives for carriers to become more productive.” *ILEC Price Cap Order* ¶ 22. Second, rate-of-return regulation produces a number of inherent inefficiencies. For example, rate-of-return regulation gives carriers especially strong incentives to “attribute unnecessary costs to their [regulated] operations in an effort to generate more revenue.” *See id.* ¶ 29. Rate-of-return regulation also causes carriers to have incentives to adopt inefficient capital-intensive or labor-intensive business practices depending on the relationship between the regulated rate of return and the cost of capital. *See id.* n.30. All of these inefficiencies must be addressed through detailed accounting and rate regulation, which themselves consume substantial industry and administrative resources.

On the other hand, as the Commission has reasonably concluded, “a properly-designed system of incentive regulation [(i.e., price caps) constitutes an] improved form of regulation, generating greater consumer benefits...” when compared to rate-of-return. *Id.* ¶ 21. But to effectively control market power while producing the benefits of incentive-based regulation, price caps must, to the extent possible, be set and then allowed to operate without ongoing efforts to adjust the rate of return. Continual tinkering with the mechanism limits its ability to achieve its goals and results in all of the inefficiencies of rate-of-return regulation.

²⁰ See, e.g., Gregory J. Vogt, *Cap-Sized: How the Promise of the Price Cap Voyage to Competition was Lost in a Sea of Good Intentions*, 51 Fed. Comm. L.J. 349 (1999) (reviewing the history of price cap regulation).

