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EX PARTE

December 19, 2002

<u>Electronically Filed</u>

Marlene H. Dortch
Secretary
Federal Communications Commission
445 Twelfth Street, S.W.
Washington, D.C. 20554

Re: *In the Matter of BellSouth Telecommunications, Inc., Tariff FCC No. 1, Transmittal No. 657*, WC Docket 02-304

Dear Ms. Dortch:

I am writing with regard to BellSouth's proposed tariff revisions, which seek to capitalize on the recent bankruptcy filings of several competitive local and long distance carriers to gain regulatory approval for radical new tariff provisions that BellSouth would use to disadvantage the remaining carriers that pose no exceptional bad debt risk. BellSouth's proposals are an incredibly overbroad response to a largely nonexistent problem. As a threshold matter, there is no need even to consider BellSouth's specific proposals, because BellSouth has not come close to demonstrating that any changes to the current and longstanding tariff protections are even necessary, given its very low levels of bad debt expense and exorbitant returns on access – which are fueled by excessive rates that already account for uncollectibles in the design of the price cap system.

In all events, the specific proposals advanced by BellSouth are unlawful and patently anticompetitive, affording BellSouth complete discretion to impose, in the form of "security deposits," hundreds of millions of dollars of costs on its new interLATA rivals. BellSouth has every incentive and an unrestrained ability to abuse these proposed tariff revisions in order to raise its rivals' costs and favor its affiliated long distance operations. BellSouth's proposals are all the more unreasonable because, although no relief is necessary, AT&T has offered a more limited alternative, allowing BellSouth to collect deposits under specific conditions that cabin BellSouth's discretion and that reduce its substantial incentives to make unreasonable security deposit demands.

A. BellSouth's Radical New Security Deposit Authority Is Unnecessary.

Most fundamentally, neither BellSouth nor any other incumbent local exchange carrier has shown that they need the new and broad authority they have requested to address the risk of uncollectibles. In fact, BellSouth and the other incumbent LECs experience very low levels of uncollectibles – generally less than 1 percent of revenues (and *never* more than 1.5 percent). As AT&T explained in its comments and in a declaration submitted by Professor Bradford Cornell, any recent increases in uncollectibles are likely caused by short-term events, such as downturns in the business cycle. As Professor Cornell explains, the 2000 and 2001 fluctuations are not significantly different than prior fluctuations and could not support any reasoned conclusion that there is a long-term trend of increased uncollectibles expense.[1]

Moreover, any recent and modest increases have had no cognizable effect on BellSouth's bottom line, for it continues to reap monopoly profits from access services. In 2001, BellSouth earned a whopping 21.22 percent rate of return on its interstate access services and an unconscionable *50 percent* on special access services. In these circumstances, providing BellSouth with even more discretion and ability to fleece captive customers would be absurd. BellSouth is correct that access reform is needed, but the focus should be on *reducing* the Bell Operating Companies' market power abuses – such as their poor and discriminatory special access performance and their bloated special access rates.

Any relief is also unnecessary because the price cap system already accounts for fluctuations in uncollectibles expense. Under that regime, any year-to-year fluctuations in uncollectibles are simply "business risks" that are endogenous to the price cap regime. Such fluctuations will either reduce or increase BellSouth's profits, but, under the design of the price cap system, such fluctuations cannot entitle BellSouth to assess higher rates. Indeed, the very purpose of the price cap regime is to hold rates and other terms constant in the face of expense fluctuations to increase the LECs' incentives to act efficiently. BellSouth cannot circumvent this feature of price caps by adopting what is in effect a massive rate increase through new security

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[1] Cornell Dec. ¶ 9. BellSouth also relied on amounts that it claims it is owed in bankruptcy proceedings as evidence of its need for additional protections, but those claims have no merit. Among other things, the amounts BellSouth claimed for 2000 and 2001 were quite small – only the claims for 2002 are significant. But virtually all of that total – about 92 percent – relates to bankruptcies filed by MCI WorldCom and Global Crossing. And those bankruptcies have been linked to massive and unprecedented instances of accounting improprieties. It would obviously be improper to base future policy that will affect all customers on such aberrations that are both unlikely to be repeated (given the serious tightening of accounting and related regulations) and not redressible through security deposit provisions (which BellSouth concedes must rely upon what is reported and cannot account for what is hidden or misrepresented). With those two claims removed, BellSouth's bankruptcy claims for the first 10 months of 2002 are only about *half* the 2001 levels.

deposit tariff provisions that would radically alter the balance of risk as between BellSouth and its captive access customers.

B. BellSouth's Proposed Revisions Are Unlawfully Vague And Anti-Competitive.

Even if BellSouth had demonstrated some limited increase in its exposure that is not already appropriately covered by the Commission's price cap rules or by its longstanding tariff prescriptions relating to non-payment risks, BellSouth's proposed tariff revisions are by no means a narrowly circumscribed and measured response to any such problem. BellSouth seeks virtually unfettered discretion to demand security deposits from its access customers based upon "credit scores" generated by proprietary credit scoring tools that, by their very design, can be manipulated to produce virtually any result.[2] What is worse, even if BellSouth's manipulation of these credit scoring tools managed to produce what BellSouth has defined to be a passing score, BellSouth admits that its "credit specialists [will] take into account current information that might negate good scores" and that "such information would override the model scores." BellSouth Direct Case at 31. Thus, BellSouth would retain complete control over whether any particular carrier would be subject to substantial deposit requirements. Because such a proposal is patently vague and provides a customer with no advance warning that it might be targeted to pay hundreds of millions of dollars in security deposits, it violates the Commission's rules providing that tariffs are unlawful unless they are "clear and explicit" so as "to remove all doubt" as to the proper application of the tariff. 47 C.F.R. § 61.2.

BellSouth's ability to manipulate credit scores by changing the inputs to the credit scoring tools (and, if necessary, overrule any "passing" score) creates unbounded discretion for BellSouth to saddle any carrier with massive deposit requirements. The unfettered right to demand a security deposit from any IXC would, as the Commission recognized in 1984, be a powerful anti-competitive and discriminatory weapon.[3] Such a right would provide BellSouth the unchecked ability to act on its incentives to raise its rivals' costs and favor its own affiliated operations by, for example, imposing security deposits on its most feared rivals, while exempting its long distance affiliate – regardless of the actual credit risks posed. Indeed, BellSouth has

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[2] These credit scoring tools are very complex and require substantial user input and customization, which can dramatically affect the output. This fact is starkly illustrated by a comparison of the credit scores that BellSouth has produced for itself and its long-distance affiliate with the scores produced, at AT&T's request, for those same companies by a Dun & Bradstreet representative. According to BellSouth, BellSouth Corporation and BellSouth Long Distance scored 5.3 and 5.9 (on a scale of one to ten, with one representing the least creditworthy). By contrast, the credit scores produced by the Dun & Bradstreet representative – using a different set of inputs and weighting factors – for the same companies was 1.5 and .86, respectively. *See* AT&T Opp. at 25-27 & Blatz Dec. ¶ 12.

[3] *See 1984 Access Order*, 97 F.C.C.2d at 1168-70.

already stated that its own affiliate would not be eligible for a deposit, even though it is precisely the type of company that, absent its ties with a Bell Operating Company, would have no established credit and should be eligible for a deposit.

BellSouth contends that its tariff revisions are not unusual or discriminatory, and would allow it to implement credit practices that are prevalent throughout American industry. However, as AT&T and Professor Cornell explained, the critical distinction here is that credit practices in other industries are disciplined by market forces, whereas BellSouth's dominance in providing access leaves its customers with no realistic alternatives from which to choose. AT&T Opp. at 8-9, 21-22, 29-30 & Cornell Dec. ¶¶ 24-25. Thus, in other industries, if a company demands a substantial security deposit from a large customer, the company risks losing the customer to another supplier who determines to offer better credit conditions. That marketplace dynamic provides a powerful incentive for companies to evaluate properly a customer's true creditworthiness, and not to request security deposits unless the harm from a default and the risk of default outweigh the potential revenues. For BellSouth, in contrast, there are rarely any market forces that discipline its credit decisions, and thus BellSouth has every incentive to abuse its authority to demand security deposits.[4]

C. The Only Reasonable Change That Could Be Made To BellSouth's Tariff Would Eliminate BellSouth's Discretion And Substantially Reduce Its Incentives To Discriminate.

While BellSouth's proposed revisions are overbroad and unlawful, there is a reasonable and targeted proposal, which AT&T outlined in an *ex parte* submitted in another proceeding and which AT&T attaches to this filing, that would allow ILECs to demand security deposits from the carriers that pose the most serious risks of nonpayment.[5] AT&T's proposal allows ILECs to obtain, on short notice, security deposits of up to two months of access charges from carriers that fail to pay a significant portion (*i.e.*, non-payment of 10% or more) of the undisputed amount of their total monthly access bills for any two months during the most recent 12 month period. AT&T's proposal is as follows:

> (1) an ILEC could seek a deposit if a customer fails to pay a significant part (specifically, 10% or more is left unpaid) of the

[4] BellSouth's reaction to its modest recent increases in uncollectibles is also not at all prevalent in other industries. Rather, when the customers of companies in competitive industries uniformly experience hard times, those competitive companies themselves often suffer as well – and they certainly are *not* able to request relief from a regulatory agency to avoid slight increases in bad debt expense. In its request to change its credit practices in response to a downturn in the business cycle, therefore, BellSouth seeks not equal treatment, but special treatment to which it is not entitled and that would seriously harm competition and consumers.

[5] *See* Letter of Michael J. Hunseder to Marlene Dortch, WC Docket 02-202 (filed Dec. 9, 2002).

undisputed amount of their total monthly access bills for any two months during the most recent 12 month period;

(2) the deposit (which could consist of cash, a letter of credit, or third party guaranty) would be equal to no more than two months of access services (calculated using the two most recent bills); a customer would be required to pay the two-month deposit within 14 days of being notified by the ILEC that the customer has become eligible for such deposit;

(3) the ILEC must pay interest on the deposit equal to the amount of interest that the ILEC seeks from customers for late payments or, if the ILEC does not impose an interest rate for late payments, then the ILEC must pay an interest rate at no less than the market rate.

This proposal provides substantial additional protections to incumbent LECs to reduce the already extremely low risk of non-payment of access, while helping to ensure that such deposit requirements are targeted to customers posing the most serious risks and cannot be used in an anticompetitive manner to harm otherwise healthy carriers. It is far superior to BellSouth's proposal, and to other proposed alternatives – most particularly, the proposal to allow incumbent LECs the ability to bill in advance *all* access customers, regardless of the risks of nonpayment, for any switched access services. As AT&T explained in its December 9th *ex parte* (which it attaches and incorporates into the record here), such an approach is patently overbroad and entirely unresponsive to the alleged problem. The advance billing proposal would require even carriers with impeccable payment records to begin paying for access services at least a month earlier, creating a significant and harmful mismatch between a carrier's revenues (which are collected after service is rendered) and its expenses, which would be billed in advance.

Given that existing tariff provisions provide BellSouth and other LECs with full protection from risks of non-payment, the Commission should simply deny BellSouth's tariff transmittal. But if the Commission takes any action, it should adopt AT&T's proposal, which would eliminate BellSouth's discretion and substantially reduce its incentives to discriminate.

Sincerely,

/s/ David L. Lawson

David L. Lawson

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EX PARTE

December 9, 2002

Electronic Filing

Marlene H. Dortch
Secretary
Federal Communications Commission
445 Twelfth Street, S.W.
Washington, D.C. 20554

Re: *In the Matter of Verizon Petition for Emergency Declaratory and Other Relief*, WC Docket No. 02-202

Dear Ms. Dortch:

I am writing with regard to the proposals made by Verizon and other incumbent local exchange carriers to obtain authority to revise the longstanding tariff prescription regarding the ILECs' ability to demand security deposits from customers with a proven history of nonpayment or with no established credit. While the LECs' proposed revisions are overbroad and unjustified, there is a reasonable and targeted proposal, which AT&T outlines below, that would allow ILECs to demand security deposits from the carriers that pose the most serious risks of nonpayment. AT&T's proposal allows ILECs to obtain, on short notice, security deposits of up to two months of access charges from carriers that fail to pay a significant portion (*i.e.*, non-payment of 10% or more) of the undisputed amount of a monthly bill for any two months during the most recent 12 month period. This proposal provides substantial additional protections to incumbent LECs to reduce the already extremely low risk of non-payment of access, while helping to ensure that such deposit requirements are targeted to customers posing the most serious risks and cannot be used in an anticompetitive manner to harm otherwise healthy carriers.

In sharp contrast, another proposed solution – to allow incumbent LECs the ability to bill in advance *all* access customers, regardless of the risks of nonpayment, for any switched access services – is unlawful, unreasonable, and extremely harmful to the industry and to consumers. Most fundamentally, such an approach is patently overbroad. The advance billing proposal would require even carriers with impeccable payment records to begin paying for access services at least a month earlier. This proposed solution is entirely unresponsive to the alleged problem. According to the ILECs, the problem is *not* that all (or even most) carriers fail to pay for access services in a timely manner. Rather, the ILECs have claimed that they have accumulated growing bad debt expense because a small minority of carriers have been unable to pay for substantial amounts of access services.[1] At most, the appropriate response to such claims is to seek to identify the limited number of carriers that pose the highest risk of non-payment, and to allow the ILECs to obtain reasonable security deposits only from those carriers. The advance billing proposal, however, turns the asserted problem on its head, and demands that *all* carriers suffer the consequences caused by the minority of carriers that are unable to pay for services.

The harm to otherwise financially healthy carriers that would result from this radical change to allow advanced billing for all access services would be both extensive and profound. Most significantly, advanced billing of switched access service (and other access services billed on the basis of usage) would create a substantial "mismatch" between expense and revenues for interexchange carriers. In virtually all circumstances, IXCs bill their end user customers for usage-based services in arrears. Because IXCs do not collect revenue for such services until well after those services are billed, any proposal allowing ILECs to bill switched access services in advance would mean that IXCs would pay for switched access services *far before* they can obtain revenue for the services they provide using those switched access services. The financial impact of that mismatch would cause severe harm even to the largest and most financially healthy IXCs.

Further, faced with a significant mismatch between revenues and expenses, and given the intensely competitive nature of the long distance market, IXCs would be severely restricted in their ability to reduce the financial effect of new advanced access billing procedures by collecting end user revenues more quickly, either by billing services in advance or by other methods. The ILECs, by contrast, face no competitive constraints in their ability to make such wide-ranging changes in their billing practices. Even if the ILECs were to incur costs to change their billing procedures, they may find it advantageous to do so simply to raise the costs of IXCs, who are increasingly rivals to the ILECs in the provision on interLATA services. The very fact that the ILECs would have authority to implement such a drastic change in billing practices creates an unwarranted and dangerous risk to IXCs.

Moreover, any change to advanced billing for switched access services would cause a whole additional set of costs and would pose substantial administrative burdens for both ILECs and IXCs. One of the very reasons that such services are now billed in arrears is that it is simply too difficult to bill in advance for services that depend on the amount of usage. The intercarrier billing process for access services is already costly and burdensome. Adding a system in which carriers are required to estimate charges for usage-based services, verify the

[1] As AT&T has shown, the actual amounts of uncollectibles for most ILECs remain less than 1 percent of revenues.

actual amounts used, and then true-up the actual amounts paid imposes another unnecessary layer of complexity.

For all these reasons, the ILECs' initial tariff revisions were – at least on their face – designed to extract deposits only from carriers that met certain "triggers" that the ILECs asserted were reasonably correlated to the risk of non-payments, and thus would exclude carriers that posed no significant nonpayment risks.[2] Although the ILEC-proposed triggers were in fact far too broad and not sufficiently linked to non-payments risks, even the ILECs recognized that it was not necessary to adopt far-reaching changes to the entire intercarrier billing process in order to remedy any perceived problem with increasing bad debt expense. Requiring all IXCs, regardless of payment risks, to be billed in advance of receipt of switched access services is therefore not merely unwise, it would be unlawful for the Commission to adopt it at this stage in the proceeding. Nothing in Verizon's Petition for Emergency Declaratory Relief or in the Commission's Notice requesting comment on the petition even hinted that the Commission might adopt policies allowing drastic changes allowing the advance billing of switched access services. In these circumstances, the Administrative Procedure Act ("APA") prevents the Commission from adopting that course of action unless it provides proper notice and seeks additional comment.[3]

The unreasonableness of any advance billing approach is even more apparent given the more targeted alternatives that the Commission could consider to address the claimed risks of nonpayment of access services. In particular, AT&T proposes the following alternative, in which ILECs would be permitted to revise their tariffs to demand security deposits from access customers in these circumstances:

> (1) an ILEC could seek a deposit if a customer fails to pay a significant part (specifically, 10% or more is left unpaid) of the undisputed amount of a monthly bill for any two months during the most recent 12 month period;
>
> (2) the deposit (which could consist of cash, a letter of credit, or third party guaranty) would be equal to no more than two months of access services (calculated using the two most recent bills); a customer would be required to pay the two-month deposit within 14 days of being notified by the ILEC that the customer has become eligible for such deposit;

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[2] In this regard, many ILECs did not even propose advance payments at all, but rather simply sought security deposits from selected carriers.

[3] *E.g.*, *Shell Oil Co.* v. *EPA*, 950 F.2d 741, 751 (D.C. Cir. 1991) (final rule must be a "logical outgrowth" of proposed rules); *Small Refiner Lead Phase-Down Task Force* v. *EPA*, 705 F.2d 506, 546-47 (D.C. Cir. 1983) (same).

> (3) the ILEC must pay interest on the deposit equal to the amount of interest that the ILEC seeks from customers for late payments or, if the ILEC does not impose an interest rate for late payments, then the ILEC must pay an interest rate at no less than the market rate.

This proposal allows the ILECs to obtain security deposits from those carriers that present a genuine risk of non-payment, and also limits the ILECs' ability to harm interLATA competition by using their authority to demand security deposits in a discriminatory fashion. The proposed "trigger" for the deposit is based on proposals by certain ILECs to demand deposits based on an customer's failure to pay two access bills in any 12 month period, or to fail to pay in any month more than $250,000 in access services. Unlike those triggers, however, the trigger proposed by AT&T is based on a customer's nonpayment of a *percentage* of an access bill, and therefore would not allow an ILEC to demand a substantial security deposit for very minor payment discrepancies. In addition, the proposal allows the ILEC to obtain the deposit quickly – in about 14 days, which is even less time proposed by some ILECs.[4] Moreover, by requiring the ILEC to pay interest on *all* deposits at a rate the ILEC employs for late payments (or a market rate), the proposal provides some limits on the ILECs' substantial incentives to demand deposits in order to raise its rivals' costs.[5]

AT&T is willing to discuss this proposal or other alternatives that target the security deposits that ILECs can demand to those access customers that have a demonstrated and serious risk of non-payment.[6] However, implementing drastic and wholly unwarranted changes to the intercarrier billing system allowing ILECs to bill all customers in advance for switched access services is both unlawful under the APA and in all events patently unreasonable, and should not be adopted.

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[4] SBC's proposed tariff revisions allowed the customer up to 21 days after notice to provide a deposit; Verizon required that the customer provide the deposit 10 days after notice.

[5] Indeed, Verizon itself has argued that requiring the payment of interest for deposits reduced its incentives to discriminate. However, because Verizon's particular proposed revisions provided that it could demand an advance payment that would be interest-free in lieu of a security deposit that would accrue interest, Verizon's proposal in fact simply provided it with incentives to choose to demand advance payments rather than security deposits to avoid paying interest.

[6] Some ILECs have proposed shortening the termination period for discontinuing access service from 30 days to as little as seven days. Although AT&T has no objection to such a procedure – provided that it applies only to carriers that present serious and genuine risks of non-payment, such proposals do not appear necessary where ILECs can rapidly obtain security deposits from customers that are not paying their access bills.

Sincerely,

/s/ Michael J. Hunseder

Michael J. Hunseder

cc: Matthew Brill
Jordan Goldstein
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