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	))))	RM No. 10593

REPLY COMMENTS OF BELLSOUTH

BellSouth Corporation, on behalf of itself and its wholly owned subsidiaries ("BellSouth"), hereby submits its Reply Comments in the above referenced proceeding.

I. INTRODUCTION

1. Taken for what it is, AT&T's petition amounts to a call to dismantle incentive-based regulation and abandon market mechanisms and to return to the days of yesteryear dominated by rigid rate regulation. Not surprisingly, AT&T's petition has garnered support from the usual group of commenters who seize upon every opportunity to increase the regulatory disparity between incumbent local exchange carriers ("ILECs") and every other provider of telecommunications.

2. As with AT&T's petition, the comments recycle old regulatory arguments in the hope that they will take on a new sheen. But, like a well worn piece of corduroy, the sheen represents age, not merit. Indeed, none of AT&T's supporters were able to accomplish what AT&T failed to do in its petition – show that pricing flexibility is a failed policy. As discussed below, there is no basis in the commenters' claims that competition for special access is lacking.

II. DISCUSSION

A. Commenters Have Not Shown That Special Access Prices Are Unreasonable

3. A principal predicate of AT&T's petition is that special access earnings are excessive and that such earnings demonstrate that rates are too high and that LECs have market power. As BellSouth demonstrated in its comments, regulatory earnings have no significance in assessing market power, nor do the data relied on by AT&T and other commenters in any way suggest that pricing flexibility is operating in an unintended way. The ARMIS data series upon which AT&T based its analysis, and which several commenters endorse, predates pricing flexibility. Thus, in essence, the challenge launched by AT&T is on price cap regulation, not pricing flexibility; but even that challenge must fail. Price cap regulation was never intended to constrain earnings. Instead, price cap regulation constrains prices and invites carriers to become more efficient and to increase earnings subject to the price cap limits. All that earnings can show is how successful a price cap carrier has been in light of the price cap formula limitations. Earnings under price caps have nothing to do with whether rates are just and reasonable.

4. Indeed, Kahn and Taylor[1] dispel the mythology enshrouding the claim that regulatory rates of return indicate market power:

> High or increasing rates of return calculated using regulatory cost assignments for interstate special access services do not in themselves indicate excessive economic earnings reflecting the exercise of market power. Indeed, regulatory rates of return for geographic subsets of single services in multi-product, multi-geographic firms bear no relationship with economic profits and thus can serve no useful purpose in determining whether pricing flexibility has or has not been excessively permissive. ILECs are integrated multi-regional firms and rely on an integrated regional management structure employing the regional physical and

[1] Declaration of Alfred E. Kahn and William E. Taylor On Behalf of BellSouth Corporation, Qwest Corporation and SBC Communications, Inc., and Verizon, Exhibit 1 to Comments of BellSouth (filed Dec. 2, 2002) ("Kahn and Taylor").

> human resources to provide a multiplicity of services. The cost allocations required render such a calculation meaningless.[2]

As Kahn and Taylor point out, AT&T has made this very same argument:

> The same considerations that led AT&T to contend that rates of return based on allocated accounting costs are "economically irrational" as a basis for pricing apply equally to RBOC interstate special access. The allocations of RBOC accounting costs between regulated and unregulated intrastate and interstate services are, of necessity, not based on cost-causation. Among interstate services, the allocation of costs to special access services requires additional, similarly arbitrary assumptions. The sources of these difficulties are obvious. Fixed and common costs permeate—indeed dominate—a telephone company's cost structure . . . . Even more important, each RBOC's network provides interstate and intrastate services, carrier services (special and switched access) and retail services (local and toll): a large fraction of these network costs cannot be assigned on a cost-causal basis to individual services.[3]

5. Indeed, sixteen years ago, AT&T's own expert acknowledged that "[f]ully allocated cost figures and the corresponding rate of return numbers simply have zero economic content. They cannot pretend to constitute approximations to *anything*."[4] His conclusion then – "[t]here just can be no excuse for continued use of such an essentially random, or, rather, fully manipulable calculation process as a basis for vital economic decisions by regulators"[5] – remains apt today. Calls by AT&T and others to dismantle regulatory reform predicated on "rate-of-return" calculations should be perfunctorily dismissed.

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2 *Id.* at 7.

3 *Id.* at 8.

4 W. J. Baumol, M. F. Koehn and R. D. Willig, "How Arbitrary is 'Arbitrary'? – or, Toward the Deserved Demise of Full Cost Allocation," *Public Utilities Fortnightly,* Vol. 120, No. 5, September 3, 1987 at 21.

5 *Id.*

B. Claims That Special Access Prices Are Too High Are Meritless

6. Some commenters seize upon AT&T's claim that high special access prices demonstrate market power and warrant cancellation of pricing flexibility. There are two variants of this claim. One is that special access prices exceed unbundled network element prices that are based on TELRIC costs.[6] The other variant is that prices for special access services in MSAs where pricing flexibility has been granted exceed special access prices in MSAs still subject to price cap regulation.[7] Neither variant is compelling.

7. As an initial matter, TELRIC is not an appropriate standard for measuring anything. As Kahn and Taylor noted:

> [W]here margins between price and incremental cost are used to measure anything, the incremental cost in question is emphatically never TELRIC. For example, the familiar Lerner index (the percentage markup of price above incremental cost) is sometimes calculated for a firm, but the incremental cost in question is the forward-looking economic cost of the firm itself, not the hypothetical cost of a perfectly efficient firm serving the entire market as a wholesale provider using a fully-modern network optimally deployed around the incumbent firm's existing switch locations.[8]

8. Apart from the fallacy of the TELRIC fable upon which some comments incessantly cling, BellSouth showed that pricing all services at incremental cost is simply an economic impossibility in an industry like telecommunications that is faced with substantial fixed and common costs.[9] Indeed, the very parties that argue that market power is evidenced when prices

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6 *See, e.g.*, WorldCom Comments at 3; AT&T Wireless Comments at 5.

7 *See, e.g.,* Ad Hoc Committee Comments at 2-3; Joint Comments of Pac-West and US LEC at 4 ("Joint Commenters").

8 Kahn and Taylor at 9-10.

9 As Kahn and Taylor put it, "price markups above incremental cost are necessary in an industry like telecommunications that is characterized by a large proportion of shared and common costs, fixed and variable. It is well-understood in the industry that it is not possible to
Footnote Continued

depart from incremental costs would also be viewed as possessing and exercising market power. For example, Kahn and Taylor computed margins in the residential long distance market and showed that margins are as large, if not larger, than those objected to by AT&T and its supporters with respect to special access.[10] The point of Kahn and Taylor's example is clear: "in industries, such as telecommunications, characterized by high fixed costs and economies of scale and scope, it is neither uncommon nor in itself incompatible with effective (but sustainable) competition to find high percentage mark-ups of price above incremental cost for individual services."[11]

9. No more compelling is the other variant of the price argument – that recent price increases in MSAs for which pricing flexibility was granted shows that pricing flexibility is not working or that LECs possess market power. In the first instance, the degree of price increases is greatly exaggerated. The only rates that BellSouth increased were specific month-to-month rate elements for DS1 and DS3 services. Services that BellSouth must provide on a month-to-month basis represent the services that have the highest transaction costs. Under price cap regulation alone, there is not sufficient flexibility to align rates properly to reflect such transactional differences between term and volume discount plans and month-to-month rates. Pricing flexibility enabled BellSouth to more properly reflect transactional differences by adjusting certain month-to-month rates.

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price each telecommunications service at incremental costs and still have a viable firm that can expect to recover all of its forward-looking costs." *Id.* at 10.

[10] *Id.* at 10-11.

[11] *Id.* at 11.

10. A fundamental flaw in AT&T's analysis and the comments that support AT&T is the presumption that price cap month-to-month rates are at the appropriate level. The forced price cap reductions for special access services do not axiomatically result in economically sound rates. To the contrary, such automatic price reductions have created regulatory distortions in prices. Such distortions are not corrected by subjecting additional rates to this mechanism, as AT&T advocates.

11. The other flaw in these parties' pricing argument is the failure to take into consideration the fact that substantial discounts off month-to-month rates remain available for DS1 and DS3 services through term plans such as BellSouth's Area Commitment Plan and Transport Payment Plan. Indeed, for DS1 services, 97 percent of DS1 revenues are associated with such term plans. Similarly, for DS3 services, 98 percent of DS3 revenues are associated with such discounted rates.[12] If BellSouth possessed the market power claimed by AT&T and its supporters, there would be no need to make such discounted rates available.

12. In addition to the discounts available under the term plans, BellSouth has also negotiated contract tariffs that offer customers volume-based discounts. These contract tariffs offer discounts over and above the term plans for a wide range of volumes, from as little as $2 million annually to over $80 million annually. For 2002, contract tariff customers will receive volume discounts amounting to approximately $9.5 million.

13. While commenters seek to reinforce AT&T's contention that the only result of pricing flexibility has been rate increases, the facts demonstrate otherwise. Pricing flexibility has enabled more rational prices to be established, and, as fully anticipated by the Commission, in

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12 The percentages are based on January-October 2002 revenues.

limited instances the price adjustments included increases. More importantly, pricing flexibility has led to a wide range of negotiated offerings, which have introduced not only volume discounts but also service level agreements that guarantee service performance. Thus, pricing flexibility has enabled the marketplace and customers to replace regulators as the determinants of the terms and conditions of transport offerings.

C. Competitive Conditions For Special Access Fully Justify Pricing Flexibility

14. Several commenters subscribe to AT&T's contention that competitive conditions for special access do not warrant pricing flexibility. Many of these commenters assert, as AT&T did, that there are simply no competitive alternatives to LEC special access.[13] BellSouth demonstrated in its comments that such arguments cannot bear scrutiny.

15. Accompanying BellSouth's comments was a report on special access competition. The report, prepared by The Eastern Management Group ("EMG"), demonstrated that the number of competitors offering special access has grown steadily and dramatically over the last fifteen years. The EMG report concluded that purchasers of BellSouth's special access services are likely to have multiple choices of competitive alternatives and that the marketplace is able to provide any level of service performance for which there is sufficient demand.

16. Moreover, Verizon, SBC, Qwest and BellSouth jointly submitted a UNE Rebuttal Report 2002 in connection with the Commission's Triennial UNE Review.[14] The UNE Rebuttal Report demonstrated that CLECs have extensively deployed their own interoffice transport and high-capacity loops. As the report shows, CLECs have deployed at least 184,000 route miles of

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[13] *See, e.g.*, Arch Wireless Comments at 3; AT&T Wireless Comments at 2-3; Comments of Cable & Wireless at 5; Joint Commenters at 5; Sprint Comments at 3.

[14] UNE Rebuttal Report 2002, submitted by BellSouth, SBC, Qwest and Verizon, October 2002, CC Docket Nos. 01-338, 96-98, and 98-147 (filed Oct. 23, 2002).

fiber, most of which is used for local transport. Wholesalers, utility companies and interexchange carriers are also supplying local fiber. By the end of 2001, one or more CLECs had obtained fiber-based collocation in BOC wire centers that contain more than half of all business lines served by the RBOCs, and in more than 60 percent of all BOC wire centers that serve over 10,000 business lines.[15]

17. In addition, CLEC fiber networks reach approximately 30,000 commercial office buildings nationwide. By the end of 2001, CLECs served at least 156 million voice-grade equivalent circuits, the majority of which they provided over high-capacity facilities that they had deployed. Significantly, CLECs purchase only a small number of high-capacity loops from the BOCs, serving the vast majority of their customers with their own last-mile facilities.[16]

18. These facts belie the claims that competition is lacking. Furthermore, these facts do not even take into account the ability of BellSouth's competitors to self-supply special access circuits.[17] As Kahn and Taylor note:

> Towards the end of the 1990s, consolidation in the telecommunications industry sharply reduced the number of these competitors, and between 1996 and 1998, the three largest consolidated CAPs were further acquired by AT&T and WorldCom . . . . As a result, the capacity (and growth prospects) for competitive wholesale

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15 UNE Rebuttal Report 2002 at 39-40.

16 *Id.* at 44.

17 In their comments, wireless carriers have echoed AT&T's claims that there are insufficient alternatives to LEC tariffed interoffice facilities. In effect wireless carriers reprise the arguments they have made in the Commission's Triennial UNE Review proceeding. BellSouth has shown in that proceeding that wireless carriers can choose from multiple true facilities-based CLECs offering service throughout BellSouth's region. Moreover, wireless carriers simply overlook self-provisioning. Historically, wireless carriers constructed their network infrastructure with the use of microwave facilities. Due to the competitive offerings provided by ILECs, wireless carriers have migrated from this approach to one that uses ILEC-provisioned private line and special access circuits. Thus, the change is based on market factors, not the absence of competition. *See* Comments of BellSouth Corporation, CC Docket Nos. 01-338, 96-98 and 98-147, at 58 (filed Apr. 8, 2002).

local exchange facilities was taken off the open market and brought in-house by the two largest IXCs (and two of the largest CLECs). Consequently, there are indeed fewer *independent* CAPs available to AT&T and WorldCom today when they seek alternatives to RBOC special access circuits; but, of course, the capacity of AT&T and WorldCom to supply these facilities themselves increased by the same amount. One cannot simultaneously acquire the major wholesale providers of special access circuits and then, invoking the orphan defense, complain about a shortage of independent supplies or suppliers on the open market![18] (emphasis in original)

III. CONCLUSION

19. In its comments, BellSouth demonstrated that there was absolutely no evidence presented by AT&T showing that pricing flexibility had failed or had resulted in unexpected outcomes. None of the parties supporting AT&T have been able to fill the factual void.

20. Despite the laments of these parties, no showing has been made that pricing flexibility has harmed competition. To the contrary, competition continues to grow. The Commission must continue its commitment to harnessing the economic power of the marketplace and to permit the marketplace to be the engine of change and advancement in the telecommunications industry. Accordingly, the Commission must unequivocally reject calls to return to the regulatory orb of the twentieth century.

Respectfully submitted,

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18 Kahn and Taylor at 24.

CERTIFICATE OF SERVICE

I do thereby certify that I have this 23rd day of January 2003 served the following parties to this action with a copy of the foregoing **REPLY COMMENTS OF BELLSOUTH** by electronic filing and/or by placing a copy of the same in the United States Mail, addressed to the parties listed on the attached service list.

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