THE DEFINITION OF "IMPAIRMENT" AND "AT A MINIMUM" UNDER SECTION 251(d)(2) AND THE *USTA* AND *VERIZON* DECISIONS.

Summary of AT&T Position

The first issue that the Commission must address before determining whether particular elements must be made available is the proper definition of the term "impairment" under section 251(d)(2). The test of impairment that it adopts will obviously govern the inquiry as to whether lack of access to particular elements in fact impairs competitive carriers in their ability to provide the services that they seek to offer, and thus whether particular elements need be made available. That said, section 251(d)(2) provides that impairment is only the "minimum" consideration for unbundling; thus, the Commission may, in appropriate circumstances, also determine whether other relevant policy considerations weigh in favor or against unbundling of a particular network element.

Competitive carriers are impaired when, absent the unbundling of a particular network element, they suffer a material cost disadvantage vis-à-vis the incumbent LEC. Whether there is a material cost disadvantage can be determined by applying established antitrust principles that are derived from the *Horizontal Merger Guidelines* issued by the Department of Justice and Federal Trade Commission, the economic principles that underlie these guidelines, and the economic and antitrust literature in general. In particular, the impairment test should focus on whether there exist economic barriers to entry through the use of alternatives to the incumbent's facilities that can be expected to prevent the market from attracting multiple competitors and becoming unconcentrated and workably competitive in the near term if unbundled access to a particularly network element is denied. As directed by the court in *United States Telecom Ass'n v. FCC*,[1] AT&T has identified three categories of "impairment" that are directly "linked" to natural monopoly characteristics of the relevant incumbent LEC facilities: (1) whether duplication of the element in question involves substantial "fixed" costs that mean that the incumbent has lower unit costs than new entrants who use alternative facilities over all applicable levels of demand; (2) whether duplication of the element in question involves substantial "sunk" costs; and (3) whether use of alternative facilities requires a new entrant to incur costs that the incumbent does not for other reasons, such that the new entrant will have higher unit costs than the incumbent over whatever range of demand the new entrant could reasonably incur.

The Commission should also reaffirm its prior holding in the *UNE Remand Order* as to the meaning of the term "at a minimum" in section 251(3)(2). That language permits the Commission to consider other factors beyond "impairment" in determining whether a network element should be unbundled. This is not a "one-way ratchet" that permits the Commission only to deny unbundling, but permits it, based on valid policy considerations, to mandate unbundling even where there is not "impairment" as well as to decline to order unbundling even where there

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[1] 290 F.3d 415 (D.C. Cir. 2002) ("*USTA*").

is "impairment." The Commission should also conclude that (with the exceptions noted in *USTA*) the previous factors that it announced are valid and apply those factors in its forthcoming order.

The remainder of this section is organized as follows. First, AT&T discusses the background of this proceeding, and the several court decisions that guide the Commission's analysis. Second, AT&T set forth its analysis of the factors that, if present, would constitute "impairment" as that term is used in section 251(d)(2), establish a definition for impairment that should govern the Commission's subsequent analysis and be the basis for subsequent findings by the State commissions, and explain why the definition is consistent with settled antitrust principles. Third, AT&T sets forth its analysis of section 251(d)(2)'s "at a minimum" language. Fourth, AT&T explains that its proposed rules are consistent with the *USTA* decision, and the Supreme Court's decision in *Verizon Communications Inc. v. FCC*[2] upholding the Commission's TELRIC methodology to set rates for UNEs. Finally, AT&T describes the role that the State commissions should play in implementing the impairment definition in the future.

A. Regulatory Background.

The Commission instituted this proceeding to determine whether its current unbundling rules remain faithful to the requirements of the 1996 Act and to the objective of promoting switch-based and other types of facilities competition. The Commission first implemented section 251(d)(1) in the *Local Competition Order*. There, it unbundled the seven basic network elements that comprise the local network and held that these network elements must be unbundled on a national basis. On appeal, the Supreme Court reversed and remanded that portion of the *Local Competition Order*. The Supreme Court found that in undertaking its impairment analysis the Commission had improperly ignored alternatives outside the incumbent's network and had treated any cost (or quality) difference as establishing necessity or impairment, even if it had no effect on the competitive carriers' ability to provide service profitably.[3]

On remand, the Commission initiated a proceeding to respond to the Supreme Court's ruling, which culminated in the issuance of the *UNE Remand Order*. In response to *Iowa Utilities Board*, the *UNE Remand Order* adopted a standard under which the Commission analyzed "alternative elements that are available through self-provisioning or from third party suppliers."[4] It asked whether lack of access to a particular UNE would, as a practical, economic, or operational matter, "preclude" competitive carriers from offering their proposed services in the case of proprietary elements (where necessity must be shown) or "materially diminish[]" their ability to do so with respect to the non-proprietary elements at issue here (for which only impairment need be shown). To make such determinations, the Commission's rules require assessment of a range of factors, including whether the competitive carrier would incur increased

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[2] 122 S. Ct. 1646 (2002).

[3] *AT&T Corp. v. Iowa Utilities Board*, 525 U.S. 366, 389-90 (1999).

[4] *UNE Remand Order* ¶ 21.

costs, delays, poorer quality service, operational or technical limitations on its services, or limitations on the ubiquity of its offerings if the UNE were unavailable.[5]

In terms of the cost disparity component of this multi-factor inquiry, the *UNE Remand Order* identified three relevant cost characteristics: (1) whether the UNE is characterized by fixed costs and economies of scale that mean that new entrants will have higher unit costs than the incumbent, "especially in the early stages of development;"[6] (2) whether deploying the facility would require the new entrant to incur a "sunk cost," that "cannot be recouped" if the firm ceases service and that erects an economic "barrier to entry" through use of alternate facilities that gives the incumbent "first mover advantages";[7] and (3) whether connecting a self-provisioned element to an incumbent's other facilities would cause new entrants to incur "additional costs" that an incumbent does not incur.[8]

In addition, in light of section 251(d)(2)'s language – which provides that "[i]n determining what network elements should be made available for purposes of subsection 251(c)(3), the Commission shall consider, at a minimum the 'necessary' and 'impair' standards" – the Commission held that it had discretion to order unbundling on the basis of additional policy considerations other than impairment.[9] In particular, the Commission held that in determining whether to order that a particular network element be unbundled, it had discretion to also consider (1) whether unbundling would "accelerate the deployment of local competition";[10] (2) whether unbundling would "promote investment and innovation by all participants";[11] (3) whether different rules would "reduce regulatory obligations";[12] (4) whether unbundling should be ordered in order to promote "certainty in the markets";[13] and (5) whether an unbundling rule is "administratively practical to apply."[14] The Commission emphasized that no one factor was dispositive and that these policy factors could be used both to mandate unbundling even where there was not impairment and to decline to mandate unbundling even where there was impairment.[15]

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5 *Id.* ¶¶ 72-100.

6 *Id.* ¶ 76. The Commission recognized that economies of scale are characteristics of "many industries," but said that the existence of "economies of scale" are "[n]onetheless . . . relevant factors" to consider. *Id.* ¶ 88.

7 *Id*. ¶¶ 75, 77.

8 *Id*. ¶ 79.

9 *Id.* ¶ 106.

10 *Id.* ¶ 107.

11 *Id.* ¶ 110.

12 *Id.* ¶ 113.

13 *Id.* ¶ 114.

14 *Id.* ¶ 116.

15 *Id.* ¶ 106.

Based on this analysis, the Commission revised the unbundling rules that it had previously issued in the *Local Competition Order*. With regard to switching, the Commission developed "discrete geographic and product market exceptions to the incumbent's duty to unbundled the elements on a national list."[16] The Commission also refused to mandate unbundling of packet switching in order to encourage investment in advanced services facilities.[17] In the subsequent *Supplemental Order* and *Supplemental Order Clarification*, the Commission also imposed interim "use restrictions" on loop-transport combination network elements that permitted competitive carriers to use these elements for exchange access services only when they were also providing substantial local service to the customer. To provide certainty in the marketplace, the Commission held that these rules (other than the interim use restrictions) would remain in effect for three years and that it would not consider "de-listing" of particular elements until that time.[18]

In 2002, the Commission initiated the first "triennial review" of its unbundling rules. Shortly after the initial round of comments in April 2002, two major judicial decisions were issued that bear directly on the issues in this proceeding. In *Verizon Tel. Cos. v. FCC*,[19] the Supreme Court upheld the Commission's network element pricing and new combination rules on grounds establishing that broad unbundling is not just permitted, but required, by the objectives of the Act. Specifically, the Supreme Court held that ending incumbents' monopolies and creating local competition is an "end in itself" under the Act and that the Act is designed to "jump-start" local competition by "reorganiz[ing]" the incumbents' monopolies to "make them vulnerable to interlopers" and by giving "aspiring competitors every possible incentive to enter local retail telephone markets, short of confiscating the incumbents' property."[20] The Court recognized that the incumbent LECs "have almost an insurmountable competitive advantage" over new entrants and that the Act is intended to allow "hundreds" of new entrants to access elements that are "costly to duplicate" even if there are some "large competitive carriers" with the "resources" to replicate the elements economically.[21]

Ten days later, in *United States Telecom Ass'n v. FCC*,[22] the D.C. Circuit remanded the Commission's *UNE Remand Order*.[23] Critically, *USTA* did not pass on the validity of the Commission's decision to order the unbundling of any of the specific elements identified in the *UNE Remand Order*, and the court of appeals did not direct the Commission to exclude any particular elements from the unbundling requirements on remand. But the court held that there

[16] *Id.*¶ 120.

[17] *Id.* ¶ 316.

[18] *UNE Remand Order* ¶ 151.

[19] 122 S. Ct. 1646 (2002)

[20] *Id.* at 1654, 1661.

[21] *Id.* at 1672 & n.27.

[22] 290 F.3d 415 (D.C. Cir. 2002).

[23] The *USTA* decision also vacated the *Line Sharing Order*.

were deficiencies in the prior orders, and gaps in evidence and explanation, that had to be remedied on remand. Of most direct relevance here, the court held, relying on *Verizon*, that the *UNE Remand Order* had adopted an impairment standard that was overbroad in one specific respect. The court concluded that the standard had improperly permitted the Commission to rely on cost disparities that were "universal" between new entrants and incumbents in all markets, rather than only those disparities that are "linked (in some degree) to natural monopoly" characteristics and that can render an element "unsuitable" for "competitive supply" by "multiple" firms.[24]

The court of appeals further concluded that the Commission's decision to adopt national unbundling rules that "apply to every geographic market and customer class" had been inadequately explained.[25] The court was concerned that the Commission may have adopted national rules because it failed to consider "market specific variations in competitive impairment," lumped all customers together into a single market, and ordered unbundling for all customers, even though there may have been large business or other customer classes that competitive carriers could profitably serve through facilities obtained outside the incumbent LECs' networks. In particular, the court stated that the Commission had not explained why it ignored the effects of the historic practice of promoting universal service by requiring incumbents to provide "underpriced" service to certain "rural and/or residential customers" and to allow incumbents to make up the difference by charging above cost-rates to other customers.[26]

In this regard, the court of appeals also held that the Commission had not sufficiently responded to the incumbents' claims that substantial overbreadth in unbundling rules is not "costless," but could lead to reduced investment by both competitive carriers and incumbent LECs. The court stated that the Commission's "only response" to this claim was to point to evidence that both incumbent LECs and competitive carriers have built facilities since the Act was passed, which, the court concluded, "tells us little or nothing" about incentives or about what would have occurred if there had been no unbundling.[27]

As explained in greater detail below, *USTA* does not mandate that the availability of UNEs must now be radically constricted. In this regard, the situation here is precisely analogous to that which the Commission faced after the D.C. Circuit had vacated and remanded the Commission's 1999 collocation rules on the ground that the Commission failed to give any "limiting" effect to the term "necessary" in section 251(c)(6).[28] The incumbents claimed that the D.C. Circuit's decision required that the collocation rules be gutted. But the record that had led to the 1999 rules had been very limited, and on remand, a detailed factual record was compiled that made the showing required under the D.C. Circuit's decision and that, for the first time, set forth the technological and economic facts that showed broad collocation was required for

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[24] *USTA*, 290 F.3d at 426-28.

[25] *Id.* at 422-26.

[26] *Id.* at 423-24.

[27] *Id*. at 425.

[28] *See GTE Services Inc. v. FCC*, 205 F.3d 416 (D.C. Cir. 2000).

competitive carriers to access loops and other facilities on nondiscriminatory terms. On the basis of this more extensive record, the Commission expanded the incumbent LECs' collocation duties (*e.g.*, by requiring collocation of certain switching equipment) in an order that the D.C. Circuit has now "easily" upheld.[29]

So too here the "gaps" of explanation and evidence that the *USTA* identified in the *UNE Remand Order* were largely products of the very limited record in that proceeding. At the time, local competition was in its infancy, and there had been no substantial actual marketplace experience with the use of UNEs or of alternatives to them. For example, competitive carriers' experience with self-provisioned switching was then essentially confined to serving customers who use DS-1 or higher capacity loops that do not require hot cuts, and there was virtually no experience with DLC (especially IDLC) loops, only trivial experience with the hot cut process, and no experience showing business customers would reject services that require hot cuts – as they since have. Due to the Eighth Circuit's erroneous invalidation of Rule 315(b),[30] there had also been no significant experience with the use of the UNE-Platform ("UNE-P") to serve residential or other customers, and because the incumbents' DSL offerings were effectively nonexistent, there was similarly no experience with the effects of intramodal competition on them. Finally, there was then no basis whatsoever to compile any statistically significant data on the effects of UNEs on investment. For all these reasons, the records in the UNE Remand and Line Sharing proceedings were primarily predictive and theoretical.

But the intervening years have resulted in extensive actual marketplace experience, both with UNEs and with competitive carriers' attempts to compete without them. In particular, this experience has allowed commenters to make extraordinarily detailed factual showings here of the effects that UNE availability have on competition and investment. Thus, to the extent this evidence shows that, in fact, competitive carriers are impaired absent unbundling, and especially if unbundling has not discouraged investment, nothing in *USTA* precludes the Commission from mandating that the element in question must be provided as a UNE.

Overall, the evidence of record demonstrates that, with a few exceptions in cases where competitive carriers are able to aggregate substantial demand in a concentrated geographic area, that "impairment" generally exists, or at least may exist, for all of the previously identified network elements. That said, unbundling rules should be "granular" and permit the "de-listing" of a network element where it can be shown that these necessary circumstances exist. Thus, in its specific rules, the Commission should identify the conditions necessary to show that impairment no longer exists. And because the data necessary to review those conditions are within the particular purview of, and are most effectively reviewed by, State commissions, the State commissions must be empowered to make the necessary determinations as to whether local conditions are competitive enough to warrant the removal of unbundling requirements in specific cases.

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[29] *Verizon Telephone Cos. v. FCC*, 292 F.3d 903 (D.C. Cir. 2002).

[30] *See Iowa Utils. Bd. v. FCC*, 120 F.3d 753, 813 (8th Cir. 1997), *rev'd*, *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 393-95 (1999).

B. The Definition Of "Impairment."

The key threshold issue that governs the Commission's analysis of the particular elements is the meaning of the term "impairment" in section 251(d)(2). Section 251(d)(2) requires the Commission, when identifying the elements that must be unbundled, to consider "at a minimum" "whether the failure to provide access to such network elements would impair the ability of the telecommunications carrier seeking access to provide the services that it seeks to offer."[31] The key term in dispute in this proceeding is the term "impair."

The record and established law and economics show that the Commission should identify three principal factors that should be evaluated in order to determine whether "impairment" exists as to a particular network element: first, whether the element in question is characterized by substantial fixed costs and declining average costs as the firm's output increases (*i.e.*, scale/scope economies); second, whether the element in question is characterized by substantial sunk costs that cannot be recovered in the event that entry turns out to be unprofitable; and third, whether duplication of the element in question requires a new entrant to incur costs that the incumbent does not, such that the new entrant will have higher unit costs than the incumbent over whatever range of demand the new entrant incurs.

These factors provide a sound basis for determining whether competitive carriers, if they were required to self-provide the network element in question, face a cost disadvantage that is both "material" and that is "linked (in some degree) to natural monopoly" characteristics of the local network. These factors are sufficiently flexible to accommodate all cognizable sources of impairment and are also specific enough that the State commissions can apply them in a manner that comports with the Act's requirements.

The aforementioned factors are reasonable constructions of impairment under section 251(d)(2), particularly in light of the fact that these factors closely track both the *Horizontal Merger Guidelines*, as well as classic antitrust principles. The *Horizontal Merger Guidelines* are a fruitful source for comparison, because in analyzing whether a proposed merger would be harmful, one of the central inquiries is the ease of entry into the market. Thus, where classic antitrust theory predicts that barriers to entry would be high, a proposed merger is more likely to harm consumers and thus to prompt antitrust enforcement action. As Professor Willig has persuasively explained, the *Horizontal Merger Guidelines* look at precisely the factors discussed above in making its inquiry.[32] Likewise, noted antitrust scholar Judge Robert Bork has opined that the "the impairment factors" set forth above – namely, economies of scale and scope, the presence of sunk costs, and the existence of other substantial cost advantages enjoyed by the incumbent in comparison to the new entrant – "are reasonable and consistent with established

[31] 47 U.S.C. § 251(d)(2) (emphasis added).

[32] *See generally See* Robert D. Willig, "Determining 'Impairment' Using the *Horizontal Merger Guidelines* Entry Analysis" ("Willig *Guidelines* Ex Parte") (attached to 12/03/02 AT&T Ex Parte); *see also* Laurence Kotlikoff, Natural Monopoly and the Definition of "Impairment"("Kotlikoff Impairment Ex Parte") (attached to 1/22/03 AT&T Ex Parte); 01/31/03 AT&T Ex Parte.

antitrust principles."[33] In sum, in adopting the requirements that the Commission considers "impairment" prior to mandating the unbundling of network elements, Congress could not have expected to preclude the Commission from employing traditional analysis embodied in the *Horizontal Merger Guidelines* and established antitrust policy and economics.

Fixed Costs. The telecommunications market is characterized by large fixed costs and declining average costs as a firm's output increases. In other words, the local telecommunications market is characterized by steep scale economies, which allow incumbent LECs to provide service at per-unit costs that are substantially lower than those of competitive carriers.[34] The average costs of deploying some elements, for example, decline "through all relevant levels of demand."[35] For example, as set forth more fully in AT&T's filings, the evidence in the record shows that transmission facilities have this characteristic. Under well-accepted economic definitions, the existence of declining costs across all levels of demand establishes that such facilities are "natural monopolies,"[36] and the absence of access to such natural monopoly facilities constitutes impairment under any reasonable definition of the term. Indeed, the *USTA* decision makes clear,[37] and the incumbent LECs' own economists agree,[38] that lack of access to facilities that have declining average costs across all levels of demand satisfies the impairment standard.

Sunk Costs. Even where new entrants may reasonably approximate the incumbents' economies of scale – *i.e.*, with respect to facilities whose costs do not decline over the entire range of demand, and thus may be duplicated by a new entrant without being wasteful, in the economic sense of the term – lack of access to certain facilities may nevertheless constitute a potent entry barrier where the facility requires the expenditure of significant sunk costs and economies of scale are substantial. Economists define a cost as "sunk" if, once it is incurred, it

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[33] 1/10/02 Ex Parte Letter from Judge Robert Bork to Chairman Michael Powell at 6-8 ("Judge Bork Antitrust Ex Parte").

[34] *See generally* AT&T, Clarke Dec.; *see also* AT&T Willig Reply Dec. ¶ 19; Willig *Guidelines* Ex Parte at 8-20; 11/25/02 AT&T Ex Parte, Atts. A & B ("AT&T Loop-Transport Cost Ex Parte").

[35] AT&T Reply, Willig Reply Dec. ¶ 19 (emphasis added).

[36] *See* John C. Panzar, *Technological Determinants of Firm and Industry Structure*, in HANDBOOK OF INDUSTRIAL ORGANIZATION, vol. 1, R. Schmalensee and R.D. Willig, eds. North-Holland, 1989, at 3-59., and Ronald R. Braeutigam, *Optimal Policies for Natural Monopolies*, in *ibid*., vol. 2, at 1289-1346.

[37] In particular, the D.C. Circuit observed that "any cognizable competitive 'impairment' would necessarily be traceable to some kind of disparity in cost," and that the "classic case where competitor duplication would make no economic sense is where average costs are declining throughout the range of the relevant market." *USTA*, 290 F.3d at 426.

[38] Alfred E. Kahn, THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS 119, 122 (1989).

cannot be re-deployed for some other use.[39] The fact that the costs of many telecommunications facilities are sunk creates a barrier to entry, because potential new entrants understand that in order to recover those costs they will need to attract sufficient revenue volumes; however, because these facilities are characterized by economies of scale, new entrants will experience higher per-unit costs than incumbents in trying to attract additional revenue. At the same time, in most cases the existing incumbent has already sunk its costs and recovered the costs of its facilities. Accordingly, it has very low marginal costs, and thus could respond to any new entry by dropping prices to short run marginal costs – a level sufficient to enable the incumbent to remain profitable, but too low to enable the new entrant to recover its investment.[40]

Thus, there is a broad consensus among economists that industries characterized by both declining average costs and sunk costs are natural monopolies that are protected by economic barriers to entry.[41] As Professor Willig explains, "even if an entrant could reasonably approximate the scale economies of the incumbent, the existence of sunk costs and the threat that the incumbent would respond with rock-bottom prices means that potential competitors will choose not to enter. In such circumstances, construction of competitive facilities can truly be 'wasteful,' because entry can result in investments in assets that ultimately cannot be used for any purpose."[42]

The incumbent LECs' testimony supports these conclusions. For example, in the past, the incumbents have argued that the Commission should adopt an "essential facilities"-type test for the Act's "impair" standard. That would require competitive carriers to make a very demanding showing because, under the antitrust laws, a facility is generally considered essential if economies of scale are so severe that it is "economically infeasible for the facility to be

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[39] AT&T Reply, Willig Reply Dec. ¶ 20; *UNE Remand Order* ¶ 75.

[40] The Commission should reject the incumbents' argument that in treating sunk costs as an entry barrier, it would be effectively holding that incumbent LECs are likely to engage in "predatory pricing." SBC Reply at 149. AT&T's argument is not that entry will be deterred on the grounds that, once a competitive carrier has deployed facilities, the incumbent will respond with below-cost rates. Rather, the point is that the presence of sunk costs deters entry *ex ante*. Thus, it is the likely prospect that the incumbent will respond to the entry by lower prices that deters the entry from happening at all. Prior Commission rulings make this precise point. *Section 257 Report*, 12 FCC Rcd. 16802, ¶ 18 n.48 (1997) ("If entry into an industry requires large sunk costs, the firm that incurs these sunk costs first (the incumbent) can have a tremendous advantage. Potential new entrants may realize that any large scale facilities-based entry into the market will probably force prices to decrease and those prices may be in fact below the point necessary to recover the sunk cost investment. As a result, facilities-based entry will be deterred."); *MCI-BT Merger Order*, 12 FCC Rcd. 15,351, ¶ 162 (1997) (same).

[41] *See, e.g.,* William J. Baumol, John C. Panzar, and Robert D. Willig, CONTESTABLE MARKETS AND INDUSTRY STRUCTURE (Harcourt Brace Jovanovich, Inc., 1982) and Dennis W. Carlton and Jeffrey M. Perloff, MODERN INDUSTRIAL ORGANIZATION (3rd Ed. Addison Wesley, 2000).

[42] AT&T Willig Reply Dec. ¶ 22; 01/31/03 AT&T Ex Parte.

duplicated."[43] That standard was flatly rejected in *USTA*. Accordingly, in light of that decision and the Supreme Court's decision in *Verizon*, the incumbent LECs' comments acknowledge that competitive carriers are "impaired" without access to facilities that are merely "expensive to duplicate," not "economically infeasible" to duplicate.[44] Indeed, the incumbent LECs recognize that "the mere presence of a single competitive facility in a particular market [does not] necessarily preclude[] a finding of impairment in that market."[45] Thus, there is a consensus that unless scale economies are sufficiently attenuated that multiple carriers can profitably duplicate the facility in question, competitive carriers are impaired without unbundled access to the incumbent's network.

The incumbent LECs likewise agree with competitive carriers with regard to the importance of "sunk costs" in local telephone networks, because "sunk costs" create substantial barriers to entry. "[W]here sunk costs are very large relative to ongoing costs, an unregulated incumbent might be able to charge a significantly supracompetitive price without attracting entry."[46] As Qwest's expert Dr. Farrell explains (in the context of local loops), "if an entrant were to build its own residential copper loops, it might rationally fear a competitive response not based on long-run costs; and if it failed to win the customer for which the loop was built, it would forfeit a large fraction of its own costs."[47] Indeed, as Dr. Farrell states, this can "be true even if there were no economies of scale in the ordinary sense."[48]

Thus, the Commission should squarely reject the incumbent LECs' argument that the presence of sunk costs, as a general matter, is unlikely to deter entry. In particular, the incumbents attack the idea that sunk costs deter entry by pointing to the example of the deployment of competitive wireless networks.[49] But the wireless example is fully consistent with this analysis, which concludes that sunk costs are a relevant consideration in determining impairment, but that sunk costs standing alone do not necessarily mean that entry will always be unlikely. In the case of wireless, there was exploding demand for wireless service that could not be served by the incumbent providers because of existing capacity limitations (including limitations on the amount of spectrum available to the incumbents).[50] Although building a wireless network does involve some sunk costs, there was not an enormous risk that this investment would be stranded because of the proven and substantial demand for wireless

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[43] *AD/SAT, Div. of Skylight, Inc. v. Associated Press*, 181 F.3d 216, 232 n.3 (2d Cir. 1999) (citing *Twin Laboratories, Inc. v. Weider Health & Fitness*, 900 F.2d 566, 568-69 (2d Cir. 1990)).

[44] SBC Reply at 9.

[45] *Id.* at 10.

[46] Qwest Reply, Farrell Reply Dec. ¶ 13.

[47] *Id.* ¶ 22.

[48] *Id.* ¶ 22.

[49] Verizon Reply, Shelanski Reply Dec. ¶ 4.

[50] Willig *Guidelines* Ex Parte at 6 n.19.

services that could not be met by existing providers. And it is precisely because of the fact-intensive nature of the inquiry that, as explained below, State commissions should be called upon to implement the general impairment rules the Commission promulgates.

Classic Entry Barriers That Prevent Facilities-Based Entry. Even in the absence of substantial economies of scale and sunk costs, the record shows that competitors will be impaired if, in the absence of unbundling, they would incur substantially higher costs than the incumbent LEC in order to self-deploy the facility in question. Indeed, this follows from the very definition of entry barrier. Economists define a barrier to entry as "a cost of producing (at some or every rate of output) which must be borne by a firm which seeks to enter an industry but is not borne by firms already in the industry."[51]

This definition is based on common sense. Entry is simply unlikely where an incumbent enjoys a significant "absolute cost advantage" over the entrant.[52] Regardless of what prices prevail in the market, a potential entrant will understand that, after entry, the incumbent could simply drop its prices below the entrant's costs. Such a pricing strategy will still allow the incumbent to remain profitable; however, by setting prices below the entrant's costs, the incumbent would make it impossible for the entrant to remain economically viable.[53]

The Commission's impairment analysis should also consider unique "first mover advantages" enjoyed by incumbent LECs that make it difficult for "second movers" to enter and compete on a facilities-basis. "One cannot assume that the market invariably will succeed in dissipating entrenched market power in an acceptable time frame or that superior products will displace inferior products that enjoy first-mover advantages."[54] These types of barriers to entry are often a result of the action of governmental authorities or private licensing organizations. "The hard reality is that incumbent firms are frequently able to secure action from such bodies to impede entry of others."[55]

Where "first mover" advantages exist, they thus constitute a barrier to entry in the classic economic definition of the term, because they mean that competitive carriers bear costs in

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[51] George J. Stigler, THE ORGANIZATION OF INDUSTRY 67 (1968); *see also Bell Atlantic-NYNEX Merger Order*, 12 FCC Rcd. 19985, ¶ 129 n.247 (1997) (same).

[52] Jean Tirole, THE THEORY OF INDUSTRIAL ORGANIZATION 306 (1990). *See also USTA*, 290 F.3d at 426 ("[A]ny cognizable competitive 'impairment' would *necessarily* be traceable to some kind of disparity in costs.").

[53] *See* Richard Gilbert, *Mobility Barriers and the Value of Incumbency*, in I HANDBOOK OF INDUSTRIAL ORGANIZATION 493 (Richard Schmalensee & Robert Willig eds., 1989) ("If a potential entrant has a cost disadvantage with respect to an established firm, this is a factor that can allow the established firm to maintain a price above cost.").

[54] Robert Pitofsky, *Challenges of the New Economy: Issues at the Intersection of Antitrust and Intellectual Property*, 68 ANTITRUST L.J. 913, 916 (2001).

[55] Bork Antitrust Ex Parte at 7 (citing Herbert Hovenkamp, FEDERAL ANTITRUST LAW § 12.4 (1994)).

deploying or using an element that the incumbent LECs do not. The principal examples in this proceeding are the additional costs that competitors must incur to extend customer loops outside the incumbent LECs' central offices to their own switches and the fact that the incumbent LECs received public and private rights of way and access to multi-tenant buildings largely at a time when they had a monopoly on the provision of services, and when local governments and landlords were willing to grant such access at minimal transaction and other costs because otherwise customers would have no access to telecommunications services.[56] The former advantage is a result of the fact that incumbents, as first movers, designed their networks so that all of their loops would terminate at the same place where they perform the switching function. Competitive carriers, as second movers, cannot reasonably expect to collect sufficient traffic in one central office to warrant the placement of a switch to serve only the customers served out of that office. Thus, they must design their networks so that they can use a single switch to access customer loops from many central offices, and in doing so they incur substantial costs that the incumbents do not. With respect to rights of way, competitive carriers must often incur substantial transaction costs and delays in negotiating their rights of way and building access agreements that are much greater than those the incumbent LECs incurred, because landlords, for example, may be unwilling to permit access to or construction on their properties necessary to allow second or third providers to access their customers. Thus, even if a competitive carrier could in theory deploy a facility at a cost comparable to the incumbent, if it cannot gain the legal ability actually to construct the facility, impairment clearly exists.

The incumbent LECs argue that these type of first mover advantages should not be the basis for a finding of impairment, because they allegedly involve "mere" considerations of timeliness and delay, and such considerations, they claim, should now be irrelevant because "[e]ntrants have had six years to build these facilities."[57] Delay is not a one-time phenomenon that occurs only when a new entrant first seeks to enter a market. Delay is not a problem simply with respect to the "start-up time required for a competitor to enter a market," but also with respect to "the time it would take a competitor that has already entered the market to expand its operations to serve more customers."[58] Even those carriers that have already entered "must be able to initiate service promptly upon the request of their customers" "in order to compete effectively."[59] New entrants affected by these types of delays cannot compete effectively, because customers are generally unwilling to order service and then wait months or years for the competitive carrier to build the loop or transport facility (or to install a switch) necessary to provide service to the customer.

Other Factors. As noted, *USTA* only called into question the Commission's prior analysis of cost disparities. Thus, the *USTA* court did not disprove of the other factors that the Commission adopted to determine the existence of impairment: timeliness, quality, ubiquity and

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[56] *See, e.g.*, Bork Antitrust Ex Parte at 7.

[57] 10/16/02 Verizon Ex Parte at 6.

[58] *UNE Remand Order* ¶ 89.

[59] *Id.* ¶ 93.

operational issues.[60] Thus, where competitive carriers are unable to self-provide facilities or obtain them from third parties in a timely fashion, at quality comparable to incumbent, in the geographic areas where it seeks to offer service, or in a manner that allows it to offer services in a manner that is operationally viable, impairment also exists.

The Benefit of UNEs in Overcoming Barriers to Deploying Competitive Local Facilities. Ensuring access to UNEs mitigates the effects of all three of the types of barriers to entry identified above. First, with respect to facilities that are characterized by fixed costs, access to UNEs permits competitive carriers to share in the incumbent's substantial scale economies.[61] UNEs can also help mitigate sunk cost barriers to entry. New entrants who purchase UNEs can use those elements to build a customer base large enough to justify the expenditures necessary to build their own facilities. In addition, because the entrant will already be providing service to customers prior to deploying its facilities, it will have real-world knowledge of the incumbent's price reaction to entry, and will thus face a diminished risk that the incumbent LEC's strategic pricing reaction would make entry unprofitable. Indeed, the *USTA* court agreed that "access to UNEs may enable a competitive carrier to enter the market gradually, building up a customer base up to the level where its own investment would be profitable," and that this was a legitimate and reasonable basis for requiring that UNEs be made available.[62]

Finally, access to UNEs also helps mitigate the incumbent LEC "first-mover" advantages. For example, as explained above new entrants – but not incumbents – have to negotiate rights of way and building access agreements to provide service, and that these costs (including the costs of delay), which incumbent LECs do not face, constitute barriers to entry that are unique to the telecommunications market. UNEs enable new entrants to respond promptly to customer requests for service by enabling them to provide service immediately using UNEs during the time period that it takes the new entrant to arrange for and deploy its own facilities (where such deployment can be done profitably). Similarly, the ability to use unbundled switching in combination with loops, especially for mass-market customers who are served by voice grade loops, enables competitors to avoid the substantial additional costs that they alone would otherwise face in order to extend their customers' loops to their own switches.

The incumbent LECs urge the Commission to ignore these considerations because of the availability of "resale." According to the incumbent LECs, "[i]f the Commission's objective is to enable entrants to build scale, the Act provides an explicit mechanism for achieving this goal: resale."[63] The availability of resale, however, is clearly not an acceptable replacement for UNEs. To begin with, the new entrants show – and the incumbent LECs pointedly do not dispute – that resale entry is unprofitable.[64] Moreover, resale applies only to existing retail *services*, and thus new entrants could not use resale to provide exchange access – thus depriving new entrants of an

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[60] *Id.* ¶¶ 62-100.

[61] *Local Competition Order* ¶¶ 11, 679.

[62] *USTA*, 290 F.3d at 424.

[63] 10/16/02 Verizon Ex Parte at 4.

[64] *Id.* at 4 (stating only that "this assertion misses the point").

important source of revenue, as well as the traffic volumes necessary to economically fill their own transport facilities. By restricting new entrants to incumbent retail service offerings with minimal wholesale discounts, resale also does not permit a new entrant to gain significant market penetration by differentiating itself on the basis of features or price. Finally, new entrants using resale would not have access to the network information relating to traffic flows that would enable them to engineer and deploy a competing network.[65]

For these same reasons, the Commission should reject the incumbent LECs' argument that special access services can be used as a substitute for UNEs. Specifically, the incumbents assert that sunk cost entry barriers will not prevent self-deployment of local telephone facilities by competitive carriers, because competitive carriers can gain access to incumbent networks at "market" rates and use that access to gain a customer base and then deploy facilities once it is clear that there is sufficient demand to support those facilities.[66] The Commission flatly rejected this argument in the *Local Competition Order* (¶ 287), and then again in the *UNE Remand Order* (¶ 354). As it explained, allowing incumbent LECs to substitute above-cost tariffed special access services for UNEs would undermine the market-opening obligations of the Act:

> If we were to adopt the incumbents' approach, the incumbents could effectively avoid all of the 1996 Act's unbundling and pricing requirements by offering tariffed services that, according to the incumbents, would qualify as alternatives to unbundled network elements. This would effectively eliminate the unbundled network element option for requesting carriers, which would be inconsistent with Congress' intent to make available to requesting carriers three different competitive strategies, including access to unbundled network elements.[67]

Notably, in its review of the *Local Competition Order*, the Eighth Circuit "agree[d]" with the Commission that relieving incumbent LECs of unbundling requirements on the ground that a UNE's functionality could also be provided in the form of a wholesale service improperly "would allow the incumbent LECs to evade a substantial portion of their unbundling obligation

[65] 11/13/03 AT&T Ex Parte at 14. *See also* 1/12/03 AT&T Ex Parte (explaining why the resale discounts available under the Act are not the equivalent of the market-based discounts that have permitted vibrant competition in the interexchange market and that BOCs are now relying upon as they provide competitive long distance and have enabled them to acquire large volumes of customers in a very short time).

[66] *See* SBC Reply, Shelanski Reply Dec. ¶ 4 (arguing that that sunk cost entry barriers are eliminated by the existence of "tariffed ILEC services"); SBC Reply at 147 ("ILEC special access services are available to serve as a bridge while alternative facilities are biding deployed."); *id.* at 149 ("[A] CLEC can buy capacity from the ILEC as a service . . . while it builds a customer base over which to spread the costs of deploying facilities."); Verizon Reply at 95 ("Further, to mitigate any delay while deploying facilities, CLECs can provide services by obtaining ILEC special access channel terminations at competitively disciplined rates.").

[67] *UNE Remand Order* ¶ 354.

under subsection 251(c)(3)."[68] And in upholding this aspect of the Eight Circuit's decision, the Supreme Court held that the "impairment" inquiry must focus on whether a requesting carrier can offer service through "self-provision, or with purchase from *another carrier*" – *not* through services purchased from the incumbent.[69]

Forcing competitive carriers to buy special access services in lieu of high capacity UNE-loops would undermine local competition. The incumbent LECs' argument implicitly assumes that the rates for access services, although higher than the TELRIC rate applicable to UNEs, are still low enough that a competitive carrier can still profitably offer service during the often substantial period in which it would use wholesale access as a "bridge." Given that TELRIC reflects the incumbents' own economic costs of accessing the facilities in question,[70] where access rates are substantially in excess of TELRIC, a new entrant would, by definition, be at significant cost disadvantage relative to the incumbent. The incumbent LECs cannot dispute that their special access rates are well in excess of TELRIC-based rates for the corresponding network element.[71] Moreover, AT&T has shown that the Bell companies' rates and profit margins for special access services have been steadily increasing over the last few years,[72] which further increases the gap between competitors' costs of using special access and the incumbents' costs for the same functionality. The record further shows that local loops represent a substantial percentage of the overall cost of finished telecommunications services.[73] Thus, if the incumbent LECs' proposal were adopted, the incumbent LECs would enjoy a substantial cost advantage over competitive carriers and could profitably underprice the competitive carrier and prevent the competitive carrier from attracting sufficient customers to be viable.[74] The competitive carrier, knowing this, would be deterred from entering.[75]

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[68] *See Iowa Utilities Board v. FCC*, 120 F.3d 753, 809 (8th Cir. 1997), *aff'd in part and rev'd and remanded in part on other grounds*, *AT&T Corp. v. Iowa Utilities Board*, 525 U.S. 366 (1999)

[69] *Iowa Utils. Bd.*, 525 U.S. at 389-90 (affirming the Eighth Circuit) (emphasis added).

[70] *Local Competition Order* ¶ 679.

[71] AT&T at 140; AT&T Reply at 287; Covad at 70.

[72] *See generally* Petition of AT&T (filed RM No. 10593, Oct. 15, 2002) ("AT&T Special Access Petition") (attached to 10/16/02 AT&T Ex Parte); *id.*, Stith Dec.; *id.*, Ordover-Willig Dec.; AT&T Reply (filed RM No. 10593, Jan. 23, 2003) ("AT&T Special Access Reply") (attached to 1/30/03 AT&T Ex Parte).

[73] Willig *Guidelines* Ex Parte at 8-10; 11/25/02 AT&T Ex Parte, Att. A & B.

[74] In effect, this would permit the incumbent LECs to price squeeze their competitors. *See generally Premier Elec. Constr. Co. v. National Elec. Contractors Ass'n*, 814 F.2d 358, 368 (7th Cir. 1987) (citing Thomas Krattenmaker & Steven Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power over Price*, 96 Yale L.J. 209 (1986)) (explaining the ability to obtain or preserve market power from raising rivals' costs); *see also Access Reform Order* ¶ 277 (explaining why carriers would be unable to compete with incumbent LECs if they have to pay more for access than incumbents); *WorldCom Inc. v. FCC*, 308 F.3d 1, 10 (D.C. Cir. 2002)

(continued . . .)

To be sure, competitive carriers have won some local customers using special access services rather than UNE-loops. But the Commission should reject any argument that this is a reason to deny competitive carriers unbundled access to loops or transport facilities at TELRIC-based rates. Congress had good reason for requiring that, where alternatives do not exist outside the incumbent LECs' networks, competitive carriers should be entitled to obtain unbundled access to incumbent facilities at a cost-based rate, not so-called "market" rates, which, given current special access pricing, do not reflect the operation of a reasonably competitive market. To the extent that competitive carriers would have to pay more than the economic costs for access to incumbents' high capacity transmission facilities, entry under these conditions would create "competition" that is viable only at the incumbent's sufferance. Where a competitive carrier must incur significantly higher costs to provide local services, an incumbent LEC can respond to entry by dropping its retail prices below the competitive carrier's costs.[76] Such a pricing strategy allows the lower-cost incumbent LEC to remain profitable; but by setting retail prices below the entrant's costs, the incumbent would make it impossible for competitors to remain economically viable.[77]

In short, the fact that some competitive carriers have used incumbent LEC special access services as an input to their own retail services shows only that some local entry is feasible where there is reason to believe that the incumbent LEC will maintain its existing, supracompetitive prices and not exploit its cost advantage. But this type of limited competition, which exists at the sufferance of the incumbent, is not sufficient to accomplish Congress' goal of driving prices towards costs. Such competition can only be accomplished where competitive

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(. . . continued)
(quoting *Anaheim v. FERC*, 941 F.2d 1234, 1238 (D.C. Cir. 1991)) (recognizing the negative impact of price squeezes on local competition).

[75] Willig *Guidelines* Ex Parte at 7-8; Judge Bork Antitrust Ex Parte at 6-7.

[76] *See, e.g., UNE Remand Order* ¶ 73 ("[i]f the cost of the alternative element is materially greater than the cost of the corresponding element from the incumbent, the requesting carrier will not be able to provide service at prices that are competitive with the incumbent's prevailing prices").

[77] *See* Willig *Guidelines* Ex Parte at 7 ("Under well-established economic theory, any such measure [that results in competitive carriers having to incur significantly higher costs than incumbents] constitutes an entry barrier, and unless a new entrant can offset these increased costs with savings in other areas, entry through alternative facilities cannot be expected. This is true even where the incumbent's prices are well above costs. In such a scenario, the incumbent could simply drop its prices below the entrant's costs. The incumbent would remain profitable even at a reduced price, but by setting prices below the entrant's costs the incumbent would make it impossible for the entrant to remain economically viable."); *See also* Richard Gilbert, *Mobility Barriers and the Value of Incumbency*, in I HANDBOOK OF INDUSTRIAL ORGANIZATION 493 (Richard Schmalensee and Robert Willig, eds. 1989) ("If a potential entrant has a cost disadvantage with respect to an established firm, this is a factor that can allow the established firm to maintain a price above cost.").

carriers are able to obtain the necessary inputs to provide telecommunications services at costs comparable to those incurred by the incumbent LECs.[78]

Conclusion. On the basis of the foregoing discussion, the Commission should adopt the rule set forth below, which establishes impairment criteria that reflect the well-recognized entry barriers discussed above and are applied generally throughout competition law and economics. Further, this rule supplies the "limiting principle" required by *Iowa Utilities Board* for determining the level of "cost disparity" that must exist before there is "impairment." Indeed, the specific tests set forth below flow directly from the *Horizontal Merger Guidelines*.[79]

A requesting carrier is impaired in supplying a telecommunications service if

(a) the production or delivery of a specific category of telecommunications service or combination of services in a relevant product and geographic market exhibits characteristics of a natural monopoly. A natural monopoly is deemed to exist if the incumbent's TELRIC-based unit costs of providing these services decline over the range of relevant market demand; or

(b) there are one or more of the following barriers to entry with respect to the individual or joint use of one or more unbundled network elements used as input(s) to a telecommunications service or combination of services in a relevant product and geographic market:

 (i) A requesting carrier must incur sunk costs that cannot reasonably be expected to be recovered within 1 year of entry even assuming it achieves a market share as high as 5%;

 (ii) Achievement of minimum viable scale requires the entrant to serve more than 5% of current market demand.

 (iii) Material barriers to entry resulting from inherent incumbency advantages exist, including the following:

  (A) A requesting carrier's additional costs of using an alternative to a TELRIC-priced UNE to produce a final telecom service amount to 5% or more of the incumbent's TELRIC costs of providing the equivalent final service; or

[78] *Local Competition Order* ¶ 710 ("Congress specifically determined that input prices should be based on costs because this would foster competition in the retail market. Therefore we reject the use of ECPR for establishing prices for interconnection and unbundled elements."), *aff'd, Verizon Communications Inc.* v. *FCC,* 122 S. Ct. 1646, 1674 n.27 (2002) (finding the Commission's decision to reject ECPR was reasonable "because [ECPR's] calculation of opportunity cost relied on existing retail prices in monopolistic local-exchange markets, which bore no relation to efficient marginal cost.").

[79] *See generally* Kotlikoff Impairment Ex Parte.

(B) Existing conditions prevent a requesting carrier from provisioning a telecommunications service in a manner equivalent in quality to the manner in which the incumbent provisions such service.

C. The Definition Of "At A Minimum."

No commenter disputes the Commission's prior holding in the *UNE Remand Order* that it may consider other policy factors in addition to whether there is "impairment" in determining whether a particular network element should be unbundled. The incumbent LECs, however, argue that the Commission may only order a network element to be unbundled if it finds impairment and, therefore, that the additional factors that the Commission consider can only serve as reasons to deny unbundling. That is wrong.

The plain language of section 251(d)(3) requires the Commission to consider "at a minimum" whether competitive carriers would be "impair[ed]" absent the availability of a network element. If Congress had intended to require incumbent LECs to unbundle an element only when it was impaired, as the incumbents now argue, then it would not have used the discretionary phrase "consider at a minimum." This interpretation is reinforced by precedent. In evaluating statutory language that required an agency to consider various factors in reaching a particular decision, the courts have held that the agency's duty to "consider" the specific factors means only that it must "reach an 'express and considered conclusion' about the bearing of a factor, but it is not required to give 'any specific weight' to that factor."[80]

Thus, where applicable, the two "substantive" policy factors that the Commission identified in the *UNE Remand Order* should be considered in its current unbundling analysis. The legislative history of the Act makes clear that it was intended to "accelerate rapidly" local competition.[81] Thus, it is reasonable for the Commission to consider whether "failure to require unbundling will cause any class of consumers to wait unnecessarily for competitive alternatives."[82] Likewise, to the extent that particular unbundling rules would clearly promote efficient investment in facilities and innovation, competition is likely to be more sustainable, intense and beneficial to consumers. Thus, the Commission may also find it reasonable to consider this factor as well.

But the Commission should also, where appropriate, consider the other "procedural" factors identified in the *UNE Remand Order*. No one disputes that, to the extent that a certain set of unbundling rules reduce regulatory burdens, that this is, all else being equal, a benefit to society. If anything, in light of unquestioned evidence regarding the decreased availability of capital to fund network expansions, especially by new entrants,[83] the need for certainty in the

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80 *Time Warner Entertainment Co. v. FCC*, 56 F.3d 151, 175 (D.C. Cir. 1995) (quoting *Central Vermont Ry. v. ICC*, 711 F.2d 331, 336 (D.C. Cir. 1983)).

81 *Joint Explanatory Statement* at 1.

82 *UNE Remand Order* ¶ 107.

83 *See, e.g.*, AT&T Reply at 8, 106-07, 127-28.

market is even greater than at the time of the *UNE Remand Order*. And, clearly, it is appropriate to consider administrative practicality given that a complex rule that may be theoretically accurate but that is difficult to implement may achieve outcomes that are less desirable than a simpler but easier to apply rule.

Finally, the "at a minimum" language permits the Commission to adopt reasonable transition rules in connection with unbundling determinations. The courts have repeatedly affirmed the legality of transitional rules to prevent or minimize disruption caused by "flash cut" changes.[84] Such measures are "a standard tool of the Commission."[85] Thus, to the extent that its unbundling analysis would lead it to make substantial changes from current unbundling rules that might threaten economic dislocation if implemented immediately, the Commission should exercise its authority to phase such changes in over a reasonable transition period. In addition, the Commission should recognize that, particularly in light of the current conditions in the capital markets, it is unrealistic to believe that competitive carriers will be able to self-deploy facilities instantaneously, even when they might not be otherwise impaired. For these reasons, in instances when existing network elements may be eliminated, section 251(d)(2) gives the Commission authority to promulgate reasonable transitional rules to protect the public interest and give competitive carriers a realistic opportunity to deploy their own facilities.

D. Consistency With *USTA* and *Verizon*.

Contrary to the incumbent LECs' claims in this proceeding, the "impairment" and "at a minimum" tests set forth above are consistent with both the *USTA* and *Verizon* decisions, and they fully respond to the concerns expressed in *USTA* regarding the adequacy of the Commission's reasoning in the *UNE Remand Order*.

1. "Impairment."

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[84] *Southwestern Bell Tel. Co. v. F.C.C.*, 153 F.3d 523, 538 (8th Cir. 1998) ("[T]his temporary transitional arrangement is not an unreasonable solution to the implicit tension between the FCC's goals of moving toward cost-based rates and protecting universal service."); *Rural Tel. Coalition v. F.C.C.*, 838 F.2d 1307, 1316 (D.C.Cir. 1988) ("[T]he allocation is a reasonable measure . . . because it is part of a transitional process, and interim solutions may need to consider the past expectations of parties and the unfairness of abruptly shifting policies.") (internal quotation marks omitted) (citation omitted); *MCI Telecomm. Corp. v. F.C.C.*, 750 F.2d 135, 142 (D.C. Cir. 1984) ("The phase-out helps to avoid undue economic dislocations."); *National Ass'n of Regulatory Util. Comm'rs v. FCC*, 737 F.2d 1095, 1135 (D.C. Cir. 1984) ("[T]he shift from one type of nondiscriminatory rate structure to another may certainly be accomplished gradually to permit the affected carriers, subscribers and state regulators to adjust to the new pricing system."); *see also* Order on Reconsideration, *In the matter of Administration of the North American Numbering Plan, Carrier Identification Codes*, 12 FCC Rcd. 17876, ¶20 (1997); Memorandum Opinion and Order on Further Reconsideration, *In the matter of Amendment of Section 64.702 of the Commission's Rules and Regulations*, 88 F.C.C.2d 512, ¶71 (1981).

[85] *Western Union Tel. Co. v. FCC*, 815 F.2d 1495, 1505 (D.C. Cir. 1987) (citation omitted).

Cost Disparity/Deployment By A Single Entrant. The incumbent LECs claim that the D.C. Circuit's decision in *USTA* precludes the Commission from requiring the unbundling of an element unless it has first found that the element constitutes a natural monopoly in the strictest sense of the term. In other words, the incumbent LECs claim that so long as a single entrant has deployed a facility or equipment in a particular market, the Commission cannot find that new entrants would not be impaired without access to that element in that market. The incumbent LECs also claim that "mere" cost disparities cannot constitute impairment under the *USTA* court's reasoning. *USTA* does not support such a reading.

To begin with, *USTA* squarely rejected the incumbents' claim that cost differences are irrelevant to impairment determinations. Indeed, the court held that "any cognizable competitive 'impairment' would *necessarily* be traceable to some kind of disparity in costs."[86] Moreover, the court found that the incumbent LECs' argument was internally inconsistent, for "the incumbent LECs argued before the Commission and the Supreme Court that the impairment standard embodies the criteria of the 'essential facilities' doctrine, which itself turns on concepts of costs" and which applies where competitive duplication would make no economic sense because average costs are declining throughout the range of the relevant market.[87]

The court of appeals concluded that the *UNE Remand Order*'s discussion of the kinds of cost disparities that can establish impairment was overbroad in a single respect, *i.e.*, that it relied on cost differences that were "universal" as between new entrants and incumbents in any industry, including competitive ones. In particular, the court focused on the Commission's observation in the *UNE Remand Order* with respect to switching that a competitive carrier is "probabl[y] unab[le] to enjoy scale economies comparable to ILECs' 'particularly in the early stages of entry.'"[88] The court noted that "average unit costs are necessarily higher at the outset for any new entrant into virtually any market" and concluded that the Commission's prior analysis had relied on "cost disparities faced by virtually any new entrant in any sector of the economy, no matter how competitive the sector" and "that are universal as between new entrants and incumbents in any industry."[89] The court observed that the Commission's analysis in the *UNE Remand Order* did not focus at all on the presence of the economies of scale "over the entire extent of the market" that render an element an essential facility and a natural monopoly, and that mean that competitive supply can turn out to be "wasteful."[90] The court concluded that "[w]ithout a link to this sort of cost disparity, there is no particular reason to think that the element is one for which multiple, competitive supply is unsuitable,"[91] and it held that the

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[86] 290 F.3d at 426 (emphasis added).

[87] *Id*.

[88] *Id.* at 427.

[89] *Id*. at 426-27 (emphasis in original).

[90] *Id*. at 427.

[91] *Id*.

Commission's impairment analysis was impermissible insofar as it "link[ed] impairment to *universal* characteristics, rather than ones linked in some degree to natural monopoly."[92]

In short, *USTA's* holding was quite narrow. The court of appeals disapproved only *one* aspect of *one* of the kinds of cost disparities that the *UNE Remand Order* had addressed: the presence of economies of scale that apply only during initial stages of entry, that are universal as between incumbents and new entrants in any market, and that thus do not constitute entry barriers. By contrast, *USTA* did *not* disapprove the *UNE Remand Order*'s reliance on whether new entrants (1) have to make large investments that are both "fixed" and "sunk" because they will be wasted if entry is unsuccessful[93] or (2) must incur costs that the incumbent does not, such that the new entrant will have higher unit costs than the incumbent over whatever range of demand the new entrant incurs.[94]

Nor can *USTA* be read to mean that so long as a *single* entrant could duplicate an element, lack of access to that element cannot constitute impairment. To the contrary, *USTA* clearly indicated that an examination of "cost disparit[ies]" that showed "that the element is one for which multiple, competitive supply is unsuitable" is a sufficient basis to require unbundling. This means that the Commission may find "impairment" even where one or two entrants might be able to deploy facilities but other competitors cannot. Indeed, the Supreme Court was quite explicit on this point in its *Verizon* decision. In *Verizon*, the Supreme Court held that the Act is designed to allow "hundreds of smaller entrants" to obtain access to elements that are "costly-to-duplicate" even if firms with the "resources of a large competitive carrier such as AT&T or WorldCom" could in fact duplicate the elements.[95] Reading these two decisions together, as the Commission must, they make clear that a UNE does not have to be a natural monopoly that can economically be provided by only a single firm, for the Act should be read to permit unbundling even if there are some "large competitive carrier[s]" that can duplicate an element.[96] Indeed, the incumbent LECs themselves have conceded that "the mere presence of a single competitive facility in a particular market [does not] necessarily preclude[] a finding of impairment in that market."[97]

The incumbent LECs' argument is also bad regulatory policy. Taken to its logical extreme, the incumbent LECs would have the Commission declare that Congress would be content with a duopoly. But as the Commission held in the *UNE Remand Order*[98] and more

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[92] *Id*. (emphasis added).

[93] *Id.* ¶¶ 75-77.

[94] *Id*. ¶ 78.

[95] *Id*.

[96] *Verizon,* 122 S. Ct. at 1672 n.27.

[97] SBC Reply at 10.

[98] *UNE Remand Order* ¶ 55 (eliminating unbundling where there is only one alternative to the incumbent carrier would create "stagnant duopolies" that would defeat the Act's objective of (continued . . .)

recently determined in the *Echostar-DirecTV Order*,[99] a duopoly can rarely be counted on to produce competitive market outcomes. Instead, it cannot be confident that consumers will obtain the benefits of vigorous unless there are multiple carriers vying in the market.

Nor should the Commission be willing to accept the related argument that carriers are generally able to deploy certain facilities to serve a particular market segment solely because a single carrier may have deployed some facilities in that segment. First, there may be niche entry in circumstances that require the entrant to face a significant cost disadvantage, but that is limited enough that it will not cause the incumbent to lower its prices below the entrant's higher costs. In such cases, the incumbent LEC may find it more profitable to retain the existing price umbrella that allows it to charge generally high rates while losing a small number of customers to the new entrant, rather than to bring prices down across-the-board to keep competitive carriers from making competitive inroads.[100] However, incumbent LECs that have obtained special access pricing flexibility are not even bound by these constraints, because they can offer individualized prices to specific customers, thus gaining the ability to "target price" their services and avoid the need to price down the entire market. Accordingly, although the existence of a pricing umbrella may make it possible for a competitive carrier to enter on a limited basis even when it has per-unit costs above the incumbent LECs, such niche competition does not achieve the purposes of the Act to drive prices toward competitive levels.[101] Therefore, the fact that limited entry that will not impose competitive pressure on incumbent LECs might be possible without the availability of a particular network element provides no basis for eliminating that element as UNE.

This analysis is consistent with established antitrust doctrine. As Professor Willig has explained:

> The fact that a single firm may be able to self-supply an element does not necessarily mean that access regulation is no longer necessary to prevent the incumbent carriers from exercising market power. The [*Horizontal Merger*] *Guidelines* recognize this point, and hold that entry is not sufficient unless "*multiple entry generally is possible* and *individual entrants may flexibly choose their scale*."[102]

(. . . continued)
"creat[ing] competition among multiple providers of local service that would drive down prices to competitive levels").

[99] *See EchoStar-DirecTV Merger Order* ¶ 103 ("[E]xisting antitrust doctrine suggests that a merger to duopoly or monopoly faces a strong presumption of illegality.").

[100] AT&T Reply, Willig Reply Dec. ¶ 24.

[101] *See UNE Remand Order* ¶ 55.

[102] Willig *Guidelines* Ex Parte at 20 (quoting *Horizontal Merger Guidelines* § 3.4) (emphasis added).

Moreover, given that "[f]ull and partial facilities-based providers constitute the large majority of the bankruptcies that have plagued the competitive LEC community with increasing frequency," the mere fact of entry also cannot be considered probative of whether additional entry is economically viable.[103] To the contrary, this evidence suggests much of the investment cited by the incumbent LECs was, in fact, "wasteful"[104] because new entrants were not able to achieve revenues sufficient to cover their costs.[105] Indeed, in light of the obvious financial difficulties facing the industry, competitive carriers report that they are severely restricted in their ability to raise capital to fund network expansions.[106] Thus, it is clear that much of the initial funding of competitive networks was irrational, and the Commission cannot expect competitors to be able to raise funds to construct their own facilities unless they have sound business plans that are grounded in the economic and competitive realities of today's marketplace.

To be sure, the incumbent LECs are correct to the extent that they argue that the existence of multiple, facilities-based competitors is relevant to the impairment analysis. Where it demonstrated that there multiple carriers that are each serving the same relevant market using their own facilities,[107] and where there is no reason to question whether such competition is sustainable, then this fact would provide evidence that barriers to self-deployment of the facility in question are less substantial. In addition, to the extent that these competitors offered "wholesale" access to other carriers, non-facilities-based carriers could turn to these alternatives and bypass the incumbent. As the Supreme Court held in *Iowa Utilities Board*, the Commission must focus on the extent to which a facility is "availabl[e] . . . outside the incumbent's network" in assessing impairment. Accordingly, in appropriately "granular" unbundling rules, where there is some evidence of a "wholesale" market for the element in question, the Commission should establish criteria for the State commissions to use to evaluate whether that wholesale market is sufficiently developed that the element no longer needs to be made available by the incumbent as a UNE at cost-based rates.

Investment Incentives. As discussed, *USTA* faulted the Commission for not determining with sufficient rigor the potential trade-off between broad unbundling that promotes rigorous local competition and the impact of the availability of network elements on the incentives of competitive and incumbent carriers to invest in local network facilities. However, that decision did *not* mandate that the Commission undertake such an analysis in assessing "impairment." To

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[103] ASCENT at 11. *See also* Willig Dec. ¶¶ 95-97 & Exh. 1 (cataloging facilities-based competitive carriers either in bankruptcy or in severe economic straits).

[104] *USTA,* 290 F.3d at 427.

[105] AT&T, Willig Dec. ¶¶ 92-95.

[106] *See, e.g.*, Eschelon at 3 ("Wall Street has little interest in providing more equity or debt for CLECs to fund additional investment in telecommunications facilities . . . [and] external sources of funding have dried up"); Covad at 71 ("[p]lacing fiber transport is an expensive business and not one that Covad could be expected to enter anew during this time of scarce capital").

[107] Evidence that competitive carriers had deployed a facility to serve *separate* markets, on the other hand, is irrelevant for the reasons explained above.

the contrary, the court addressed this issue only in the context of assessing whether the Commission's reliance on factors *other than impairment* in the broader section 251(d)(2) analysis was sufficient to sustain national unbundling requirements. And it was only in that context that the court stated that the Commission should not have reviewed factors in favor of ordering unbundling without also analyzing other factors that would have led to more limited unbundling.[108] Thus, *USTA* requires the Commission to undertake an express determination of the impact of unbundling on investment incentives *only* when it seeks to order unbundling on the basis of factors other than impairment.[109]

Countervailing Competitive Carrier Advantages. The Commission should likewise reject the incumbent LECs' claims that it must examine the so-called "countervailing advantages" allegedly enjoyed by new entrants by virtue of being free of the obligation to provide service, at assertedly below-cost rates, to rural or other high-cost customers before requiring unbundling of an element. Limiting access to UNEs on the basis of such considerations would be improper, especially on the basis of this record, for three independent reasons.

First, whether the incumbent LECs in fact provide service to a significant number of customers at rates that are actually below-cost is a very complex empirical question that depends not only on examining the incumbent LECs' retail rates for basic local services (the only rates sometimes kept low by regulators) but also their revenues from selling complementary services and vertical features, as well as the revenue they obtain from access services. The incumbent LECs have provided no factual basis on which to evaluate this claim, and the Commission should refuse to override a finding of impairment based merely on unsupported arguments.

Second, section 254 of the Act requires that any implicit subsidies that have been built into retail rates for telecommunications services *must be eliminated* and replaced with a "competitively neutral" method of funding universal service that is explicit and portable – so that universal service support mechanisms have *no effect* on competition for *either* "below-cost" or "above-cost" customers. Indeed, because of section 254's separate mechanisms, the Supreme Court has already held that historic methods of funding universal service are irrelevant to unbundling determinations under the Act.[110] Congress intended that the States would eliminate the implicit subsidies that thwart competition, and permitting entry on the basis of UNEs will heighten the pressures on the incumbent LECs to do so. Congress certainly did not intend the Commission to limit competition in order to preserve the system of implicit subsidies that it wanted to eliminate.

Third, the detailed factual, engineering and economic evidence of impairment that AT&T and others have submitted shows that new entrants are impaired even in their ability to provide service to the purportedly "above-cost" customers at prevailing retail rates that already reflect

[108] *USTA*, 290 F.3d at 423-24.

[109] In fact, given the express language of section 251(d)(2), which makes impairment the only factor that the Commission is required to consider, the court would have exceeded its authority if it *required* the Commission to consider any factor other than impairment.

[110] *See Iowa Utils. Bd.*, 525 U.S. at 392-93.

any existing subsidies. In particular, competitive carriers have been unable profitably to serve "above-cost" large business locations through alternative loops or transport facilities, or to provide service to customer locations served with voice-grade loops using their own switches, each of which demonstrates a "net impairment."[111]

Further, an economically appropriate impairment analysis must focus on *cost disparities*, not existing retail rates. Regardless of current margins, entry is unlikely where the incumbent LEC has an "absolute cost advantage" relative to the entrant.[112] This is basic economics. Where a competitive LEC must incur significantly higher costs to provide local services, an incumbent LEC can respond to entry by dropping prices below the competitive carrier's costs.[113] Such a pricing strategy will still allow the lower-cost incumbent to remain profitable; but by setting prices below the competitive LEC's costs, the incumbent LEC would make it impossible for the competitive LEC to remain economically viable.[114] Entry under these conditions would be at the sufferance of the incumbent LEC and could be stamped out at any time.[115]

Moreover, entry that is sufficient only to prevent incumbent LECs from increasing charges that, in many circumstances, are already above cost does not fulfill the pro-competitive goals of the Act. The Act requires network elements to be priced at levels that reflect the incumbent's economic cost of providing those elements in order drive retail prices to levels that would exist in competitive markets.[116] Entry that is only possible where rates remain substantially in excess of costs does not satisfy this policy goal

Thus, the existence of an above-cost retail rate does not mean that a competitive carrier can be expected to enter the market if its costs are substantially in excess of the incumbents. *A fortiori*, competitive carriers are impaired in offering service even when basic service rates are priced below cost. For these reasons, considerations of universal service cross-subsidies are irrelevant to a determination of impairment.

Intermodal Competition. Finally, the D.C. Circuit in *USTA* also stated that the Commission is required to "consider the relevance" of competition from so-called "intermodal" sources (*e.g.*, cable) in deciding whether a network element should be unbundled.[117] Although some have argued that this holding requires the Commission to consider "intermodal"

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[111] *USTA*, 290 F.3d at 423.

[112] Jean Tirole, THE THEORY OF INDUSTRIAL ORGANIZATION 306 (1988).

[113] Willig *Guidelines* Ex Parte at 7; Bork Antitrust Ex Parte at 2-3.

[114] *See* Richard Gilbert, *Mobility Barriers and the Value of Incumbency*, in I HANDBOOK OF INDUSTRIAL ORGANIZATION 493 (Richard Schmalensee and Robert Willig, eds. 1989) ("If a potential entrant has a cost disadvantage with respect to an established firm, this is a factor that can allow the established firm to maintain a price above cost.").

[115] *See generally* 1/31/03 AT&T Ex Parte.

[116] *See Local Competition Order*, 11 FCC Rcd. 15499, ¶ 679 (1996).

[117] *See USTA*, 290 F.3d at 428-29.

competition in its unbundling analysis, the court of appeals' made this finding only with regard to the Commission's *Line Sharing Order* and made no such pronouncement with regard to its analysis of the *UNE Remand Order*. Specifically, incumbent LECs argue that intermodal competition renders unbundling unnecessary in two areas: broadband services and POTS loops. But even assuming that *USTA* should be read as requiring the Commission to consider intermodal competition in undertaking an impairment analysis, alternative modes of competition do not generate sufficient competitive pressure on incumbent LECs to justify elimination of the unbundling requirements.

At the outset, there is no evidence that the fact that certain intermodal providers have established their own facilities-based, non-wireline offerings means that other requesting carriers generally could establish similar facilities-based offerings or obtain access to the intermodal providers' networks. The only intermodal offering today of any significance is cable, and the record demonstrates that new entrants cannot match the cable companies' ability to deploy loop functionality. Cable companies' potential to offer telephone service arose primarily because their cable networks, which were built to provide cable television services, (1) were proven in economically on the basis of a separate revenue stream from a completely different service (program distribution); (2) were initially constructed, like the incumbent LECs' networks, as franchised monopolies; and (3) exhibit scale economies and other monopoly-derived advantages similar to those of the incumbent LECs. Competitive LECs could no more replicate the cable companies' networks and match the cable companies' scale economies than they could hope to replicate the incumbent LECs' networks.[118] Equally important, even if cable telephony were widely available (and as explained below, it is not), cable telephony providers have no legal obligation to unbundle their networks, and there is no evidence that cable companies can or will voluntarily offer unbundled access to their networks.[119]

In short, in the absence of a requirement that incumbent LECs provide unbundled access to broadband and copper loops, the record indicates that requesting carriers would have no alternative means to provide the services they seek to offer. Thus, if the Commission were to eliminate these unbundling requirements, the only competitive alternative to the incumbent LECs would be the existing intermodal competitors.

Rather than arguing that requesting carriers generally can build or obtain access to alternative networks such as cable networks, the incumbent LECs argue that existing intermodal competition is substantial enough, by itself, to render UNE-based competition unnecessary. With respect to services provided over both broadband and copper loops, however, such intermodal competition is insufficient at this time to obviate the need for unbundling requirements, and indeed, that continued unbundling is required to promote and sustain effective competition.

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[118] 2/03/03 AT&T Ex Parte at 6-7. Competitive telecommunications carriers could not hope to duplicate a cable company's broadband entry costs, given the enormous economies of scope that cable operators enjoy between video programming services and high-speed Internet access services (and other services) provided over the same wires. *Id.*

[119] The same is true for satellite and fixed wireless providers.

With respect to broadband services, intermodal competition from cable and other providers is insufficient to provide a fully effective competitive market. The only significant intermodal competitors to the incumbent LECs today are the cable companies, and cable does not provide a fully effective alternative for several reasons. First, incumbent LECs do not face ubiquitous competition for their DSL services from cable. Indeed, the incumbents have recognized that "the geographic scope of the market for broadband access is local,"[120] and, as the Commission has previously stated, what is true "for any technology" in the early stages of development is particularly true for broadband: deployment "is not uniform across the nation."[121] As the Commission has found, in some residential areas cable service is not available to anyone.[122] For example, "forty-five percent of Californians that live in cities with broadband service have DSL service as their only broadband option."[123]

Equally important, the evidence shows that cable is not generally available in business districts at all. Virtually all small business customers of cable are in suburban areas that contain or are immediately adjacent to residences. Thus, the record indicates that "[m]ore than 80 percent of midsize and small businesses are sufficiently close to a telephone-switching office to subscribe to DSL, whereas cable, having started out as an entertainment medium, reaches fewer than 20 percent of such businesses in the United States."[124] Perhaps the best evidence that DSL generally does not face facilities-based competition for small businesses is the incumbent LECs' DSL pricing – the same or similar broadband services provided to businesses are much more expensive than the services provided to residential customers.[125]

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[120] 12/23/02 AT&T Ex Parte at 6 (quoting BellSouth ILEC Dominance Reply Comments, Harris Dec. ¶ 6 (filed CC Docket 01-337, Apr. 22, 2002)).

[121] *Second Section 706 Report* ¶ 1.

[122] *See Third Section 706 Report*, App. C, Table 9.

[123] *See* 12/23/02 AT&T Ex Parte at 4-5 (quoting California Wireline Broadband Classification Comments at 28 (filed CC Docket No. 02-33, May 3, 2002)); *see also* McKinsey & Company and JP Morgan, *Broadband 2001*, Chart 25 (Apr. 2, 2001) ("*Broadband 2001 Report*") (estimating that only 33% of consumers had a choice of DSL and cable modem services and that 38% had DSL as their only option).

[124] *DSL Will Win Where It Matters*, McKinsey & Co. (July 2001); *see also* 2/4/03 AT&T Ex Parte.

[125] For example, Qwest offers 256 kbps residential DSL at $39.95, but charges between $79 and $139 per month for 256 kbps business DSL. *Compare* http://qwest.com/residential/products/dsl/index.html *with* http://www.qdslonline.com/prod/offer.html). Similarly, "T1 and fractional T1 continue to prosper. ILEC sales forces are motivated to sell T1 first and DSL second. . . . The ILECs have done very little to push DSL to small businesses." Yankee Report at 3 (August 2002). Overall, "[e]ven though business subscribers only represent 23% of the total DSL subscribers, they comprise 56% of all DSL revenues in the US . . . . On average a business customer's DSL service will amount to a $200.00 charge monthly." 2002 In-Stat Report.

Even if cable alternatives were more widely available, elimination of the unbundling requirements would leave only a duopoly, which the Commission has repeatedly found insufficient to meet the public interest.[126] Although the incumbent LECs argue that additional intermodal alternatives are available from satellite and fixed wireless providers, the evidence is that these platforms are not adequate substitutes for the vast majority of consumers. Satellite-based services are generally high-speed in only one direction and have attracted few subscribers, as even the incumbents acknowledge.[127] And there is no evidence this situation is likely to change soon, because the current generation of satellite-based offerings cannot be considered viable.[128] The incumbent LECs also overstate competition offered by fixed wireless carriers.[129] Fixed wireless technology has failed to gain even a toehold in the market,[130] and Sprint and WorldCom, the largest holders of multichannel multipoint distribution services ("MMDS"), have put their initially aggressive plans to deploy fixed wireless systems on hold.[131] Similarly, the largest holders of Local Multipoint Distribution Service ("LMDS") spectrum are in bankruptcy.[132]

As explained above, the existence of a single competitor is not a sufficient basis to eliminate the unbundling requirement. Indeed, a cable-incumbent LEC duopoly in broadband services would be insufficient to ensure fully effective competition in advanced services, for several reasons. As AT&T has explained in detail,[133] incumbent LECs do not have optimal incentives to compete fully when it comes to broadband services, because as the incumbents themselves concede, broadband services "are increasingly likely to cannibalize the traditional services offered by ILECs."[134] In particular, DSL services often lead to cancellation of second

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[126] *UNE Remand Order* ¶ 55; *EchoStar-DirecTV Merger Order* ¶ 103.

[127] AT&T, Willig Dec. ¶¶ 204-08; AT&T Reply at 94-95; *see also* ILEC Report at IV-21 ("Subscribership for broadband satellite remains low.").

[128] AT&T Reply at 94-95 (discussing how existing satellite providers are shutting down or scaling back service). As one analyst colorfully puts it, satellite broadband service is "[c]haracterized by difficult, expensive installations, notoriously poor service, and suspect performance, [so that] the service meant for anyone who can't get cable or DSL has ceased to be a serious option." Brad Grimes, *Ditch Your Dial Up*, PC World (Feb. 27, 2002) (available at http://www.pcworld.com/features/article/0,aid,73865,pg,3,00.asp).

[129] *See* BellSouth Reply, Harris Reply Dec. ¶ 12.

[130] AT&T, Willig Dec. ¶ 87; AT&T Reply at 96-98.

[131] Hillary Smith, WorldCom, *Sprint on MMDS Hold in Search of Infrastructure, RCR Wireless News* (Apr. 22, 2002); *see also* Jim Barthold, *Restarting Fixed Wireless: We're Still Waiting*, Telephony (Feb. 11, 2002).

[132] AT&T, Willig Dec. ¶ 87.

[133] *See generally* 12/23/02 AT&T Ex Parte; 2/03/03 AT&T Ex Parte.

[134] BellSouth Reply, Att. 1, NERA Reply Report ¶ 167 (emphasis added). *See also* Goldman Sachs, *Telecom Services*, at 15 (June 11, 2002) ("[A] negative side effect of adding a DSL subscriber is the potential loss of a second line that the customer had previously subscribed to.

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phone lines (which earn higher margins than DSL),[135] and DSL is also a substitute for premium-priced T1, fractional T1, and ISDN services that the incumbent LECs provide to small businesses.[136] Because of this "cannibalization" effect, incumbent LECs do not price DSL competitively but instead attempt to price DSL high enough to stem the migration from legacy incumbent LEC services to DSL, but not too high so as to cause mass customer migration to cable. This lack of effective competition has been confirmed in the past year by the incumbent LECs' ability to retain and gain DSL customers even though they raised DSL prices by 25 percent, and even though those price increases were not matched by the cable companies.

A rule that would eliminate "broadband unbundling" based on the existence of a single competitor would also be contrary to section 706, which requires the Commission to promote the deployment of advanced services. A multiplicity of competitors, rather than a cable-incumbent LEC duopoly, will better spur competitive responses throughout the market, both in terms of facilities deployment and competitive pricing.[137] Indeed, the evidence in the record demonstrates that the existence of competitive DSL providers produces greater competitive discipline on the incumbents than the cable-incumbent LEC duopoly alone.[138] Competition, as opposed to duopoly, will better promote the general availability of advanced services, as Congress directed in Section 706.

As to POTS loops, the record is even clearer that intermodal providers do not provide sufficient competition to justify elimination of the unbundling requirement. The incumbents argue that cable and wireless carriers offer services that are effective substitutes for services offered over copper, voice-grade loops, and that the availability of these substitutes renders unbundling of copper loops unnecessary. On the basis of the evidence in the record, including the evidence submitted by the incumbents themselves, these contentions are not supported.

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SBC estimates that as much as one-half of customers with second lines that sign up for DSL service disconnect their second lines, Verizon estimates that this figure is closer to three-quarters. . . . Second lines generate only $25 per month in revenue and come at a very low incremental cost to the provider, implying very high returns. Alternatively, DSL requires significant upfront acquisition costs as well as infrastructure costs. . . . *A DSL subscriber often comes at the expense of a disconnected second line, which means $25 in high-margin revenues are lost.*") (emphasis added).

[135] BellSouth Reply, Harris Reply Dec., Att. 2 (DSL Business Case) at 3.

[136] Yankee Report (August 2002).

[137] *See* Letter from William J. Baumol, Laurence J. Kotlikoff, William Lehr, John W. Mayo, Janusz A. Ordover, Frederick R. Warren-Boulton & Robert D. Willig to Chairman Powell and Commissioners Abernathy, Adelstein, Copps and Martin. Donald L. Evans *et al.* (Feb. 5, 2003).

[138] After the collapse of the data LEC industry, the incumbent LECs responded by raising their prices by 25% and ending the prior practice in which their retail services that used the lowest-speed Internet access service had been priced at the same level as cable modem service. *See* 12/23/02 AT&T Ex Parte at 5 (citing Comments of AT&T, Willig Dec. ¶¶ 21-23, 102-13, (filed CC Docket No. 01-337, Mar. 1, 2002)).

For example, cable telephony is still in its infancy and does not provide a fully effective alternative to the incumbents' wireline services. To date, cable telephony serves only a tiny fraction of the local market.[139] Moreover, cable offerings generally are limited to residential areas and, therefore, are not a legitimate alternative to most businesses.[140] Equally important, cable providers are, if anything, scaling back or abandoning plans to provide local phone services.[141] As analysts at the October 7, 2002 en banc meeting made clear, cable operators generally intend to use their limited capital to upgrade their video offerings rather than to fund entry into local telephone markets.[142] And as noted above, even if cable telephony were more widely available, cable telephony providers have no legal obligation to unbundle their networks, and there is no evidence that cable companies voluntarily provide access to their networks.

Here again, even if cable providers in some markets have been able to profitably provide telephony that is comparable in quality to the incumbent LECs' offerings, that would at most establish the existence of a duopoly (and even then, only for residential customers) – it would not enable customers to achieve the benefits of a vigorously competitive market. The legislative history shows that Congress was well aware that cable operators had plans to use their networks to provide telephony, and yet it enacted a statute giving any requesting carrier the right to obtain access to incumbent LECs' network elements. Congress clearly was not content with duopoly as a goal.

Indeed, Congress did not appear to regard cable telephony as sufficient, by itself, to warrant de-listing of loops. As explained by Congress,

> meaningful facilities-based competition is possible, given that cable services are available to more than 95 percent of United States homes. Some of the initial forays of cable companies into local telephony therefore hold the promise of providing the sort of local residential competition that has consistently been contemplated. For example, large, well established companies such as Time Warner and Jones Intercable are actively pursuing plans to offer local telephone service in significant markets. Similarly, Cablevision has recently entered into an interconnection agreement with New York Telephone with the goal of offering telephony on Long Island to its 650,000 cable subscribers.[143]

Despite that expectation (and the concomitant requirement that incumbent LECs make interconnection available to facilities-based carriers), Congress required incumbent LECs to

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[139] *Local Telephone Competition*, Table 5 (Feb. 2002).

[140] *See, e.g.*, AT&T, Willig Dec. ¶ 205; AT&T Reply at 161; 2/4/03 AT&T Ex Parte.

[141] *Cable Companies Take Slow Road To Telephony Rollout* (http://216.239.39.100/search?q=cache:9JOrapnrXGwC:biz.yahoo.com/djus/021224/1401000192_1.html+comcast+cable+telephony&hl=en&ie=UTF-8).

[142] *See* 10/7/02 En Banc Tr. at 79-80 (Warner).

[143] *See Joint Explanatory Statement* at 148.

make network elements available on an unbundled basis. Indeed, the Joint Explanatory Statement expressly identifies local loops as an unbundled network element.[144]

The record evidence also shows that wireless telephony is not a viable alternative to unbundled loops in today's marketplace, for several reasons. Wireless services today still do not offer the same functionality or service quality as wireline services, and the data capabilities of wireless services are decidedly inferior to wireline. For example, while wireline service is engineered to produce call completion rates in excess of 99.9%, wireless systems fail to complete (or drop) 30% or more of calls.[145] Wireless carriers are also generally unable to offer E911 capabilities today, in contrast to wireline carriers.[146]

For these reasons, there is no evidence that consumers are abandoning wireline for wireless services except in very limited circumstances.[147] The incumbent LECs' own data submissions indicate that only "3 percent of wireless subscribers" – which is itself a subset of all telephone users – have "abandoned wireline in favor of wireless entirely."[148] Moreover, industry analysts uniformly predict that wireless substitution will remain minimal – *e.g.*, by 2005-06 the cumulative impact of primary line replacement by wireless will be only reach about 2-3 million lines, a tiny percentage of the total demand.[149]

Thus, the evidence in the record amply demonstrates that wireless services today have made no appreciable impact in the local market. The wireless substitution that has occurred is overwhelmingly confined to the long distance market and to second lines.[150] The incumbents have produced no evidence that wireless services are a significant alternative to the local loop.

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[144] *Joint Explanatory Statement* at 116; *see also UNE Remand Order* ¶ 55 (Congress was not content to create a duopoly).

[145] AT&T Reply at 25-26, 162.

[146] AT&T Reply at 162.

[147] *See, e.g.*, Vince Vittore and Glenn Biscoff, "Access Line Count Evaporating," Telephony, October 14, 2002 ("[w]ireless substitution remains statistically insignificant at the national level").

[148] ILEC Report at IV-13.

[149] For example, the Forrester Research Report, *Sizing US Consumer Telecom* (January 2002), at 9, estimates that only 2.3 million primary lines will be disconnected and replaced by wireless over the period 2001 to 2006. Similarly, the IDC *Wireless Displacement of Wireline Forecast and Analysis*, 2001-2005, projects 1.2 million primary lines displaced by 2.5G and 3G Wireless (Figure 21, page 27) and about another 1.5 million from 1G and 2G wireless technology (compare Figure 14, page 22 and Figure 10, page 18), for a total of 2.7 million lines. In fact, the same figures from the IDC report show no primary line displacement in 2001 by 2.5G and 3G technology and in the range of 1 million primary line displaced by 1G and 2G.

[150] *See, e.g.,* Further Notice of Proposed Rulemaking and Report and Order, *Federal-State Joint Board on Universal Service, et al.*, 17 FCC Rcd. 3752 (2002) (noting that the availability of

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In short, intermodal competition for broadband and voice-grade services is still in its earliest stages and does not provide alternatives today that would ensure a fully effective and vigorously competitive local market in the absence of access to unbundled loops. Therefore, access to unbundled loops remains necessary to "enhance competition" and to realize the full potential for competition that Congress envisioned when it enacted the 1996 Act.[151]

2. "At A Minimum."

In *USTA*, the court declined to uphold the Commission's national unbundling list on the basis of the five policy considerations set forth in the *UNE Remand Order* and that were discussed above.[152] The court of appeals, however, did not call into question the legitimacy of any of these considerations. Rather, the court concluded that the Commission did not explain in sufficient detail why these policy justifications supported an "undifferentiated national rule for each element."[153]

For example, the court agreed with the Commission that "national rules" could be supported on the grounds of marketplace certainty and administrative practicality, but faulted the Commission for failing to provide an explanation as to why these factors were not controlling with regard to the "partial rule" for local switching.[154] Likewise, the court did not question the need to consider whether unbundling rules would result in reduced regulation, but concluded that the Commission had not explained why a national list was more "deregulatory" than issuing a "partial one."[155] And on the issue of whether particular unbundling rules encourage investment, competition and innovation, the court affirmatively agreed that these were relevant considerations, but concluded that the Commission had not addressed the issue with sufficient specificity.[156]

Accordingly, nothing in *USTA* precludes the Commission from considering these policy justifications in determining whether to adopt a particular unbundling rule or set of rules. In this regard, it should be emphasized that the court's criticisms are by definition inapplicable to the rules that should issue here, because the Commission need not be issuing "undifferentiated national rule[s] for each element" and, in formulating its unbundling rules, the Commission can

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wireless services has led to substantial erosion of traditional interexchange traffic and is increasingly a substitute for payphones and second lines, but is a substitute for primary wireline services in only a small number of cases).

[151] *See USTA*, 290 F.3d at 429.

[152] *Id.* at 423-24.

[153] *Id.*

[154] *Id.* at 423.

[155] *Id.* at 423-24.

[156] *Id.* at 424-25.

rely expressly on the substantial evidence, including "multiple regression analyses" showing that unbundling does not negatively impact invest in local network facilities.[157]

E. The Role of The State Commissions In Identifying UNEs.

The final threshold issue to be addressed is the role of State commissions in implementing the impairment rule the Commission adopts and in identifying UNEs that must be unbundled. For the reasons discussed below, the State commissions must be allowed to apply the Commission's general impairment rule to particular geographic, market and other factual factors in determining whether particular elements should be de-listed in particular circumstances. Further, the Commission has no authority to preempt the State commissions from adopting additional, pro-competitive unbundling rules that further the purposes of the Act.

Although the evidence of record shows that new entrants would be impaired without access to all of the elements that currently are found on the national list, subject to few exceptions, it is appropriate for the Commission to set forth a general analysis of impairment, and to rely on the State commissions to apply that analysis to the myriad of factual circumstances that exist in the different states. Allowing the State commissions to play this role is far more likely to attain the "granular" analysis that the D.C. Circuit suggested is appropriate, because the State commissions are far better situated than the Commission to examine the detailed local facts necessary to review the market, geographic, and customer characteristics relevant to the impairment analysis. Not only are they closer to the facts and competitive circumstances in their jurisdictions, State commissions also have effective mechanisms to collect, sift and test the evidence needed to make these important decisions.

The State commissions have requested the opportunity to be an active part of any "de-listing" process, and it is appropriate that they be permitted to apply the Commission's general unbundling rules to particular circumstances. In the interim, however, with certain exceptions, the existing list of UNEs (including access to unbundled local switching regardless of earlier imposed line limits)should remain in place while they conduct their reviews. This is appropriate even under the requirements of *USTA*, because as explained more fully in AT&T's and other carriers' evidence with regard the individual elements, new entrants would be impaired in their ability to provide telecommunications service without access to each of the elements on the current national list. Indeed, some elements, such as all but the highest capacity transmission facilities, are likely to constitute "pure" natural monopolies in almost every circumstance. Lack of access to other elements, such as local switches, will almost universally impair new entrants in their ability to compete because the evidence shows that, at least on a national basis, an entrant that deploys its own switch to serve residential and small business customers is at a significant cost disadvantage relative to the incumbent.

At the same time, new entrants and consumers would be irreparably harmed if the Commission allowed the current national list to expire and then call on the State commissions to

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[157] *See generally* AT&T Reply Comments, Willig Reply Dec., Technical App.; Willig, Lehr, Bigelow & Levinson, *Stimulating Investment and the Telecommunications Act of 1996* (attached to 10/11/02 AT&T ex parte filing); AT&T Reply, Clarke Reply Dec.

affirmatively identify and list elements. The competitive carrier industry, which is already reeling from a spate of bankruptcies, reasonably made business plans and attracted capital, based on the existing unbundling rules. Thus, eliminating any UNEs on a flash cut basis would wreak havoc with their business and significantly impair competition. This cost is especially unacceptable, given the general evidence of impairment on a national basis. Most critically, customers –many millions of whom today obtain service via the UNE Platform (or "UNE-P"), and millions more via particular elements – would likewise experience hardship if they were to lose service from elimination of the UNEs, especially if such elimination were to prove unjustified on the basis of locally specific facts. For these reasons, the Commission should, with the limited exceptions set forth in AT&T's filings, leave the current national list of UNEs in place, but to authorize the State commissions to de-list, or partially de-list, particular elements in their states if such de-listing is appropriate under application of general impairment rules.

This approach is fully supported by the "at a minimum" criteria. As explained, the Commission is permitted to mandate unbundling on the basis of reasoned policy factors, including "administrative" factors, even in the absence of "impairment." Again, it cannot be overemphasized that the elimination of UNEs for which there is actual impairment could impose severe harm on competitive carriers that rely on them, even if there is the prospect that State commissions would eventually would reinstate the UNE. And these harms could be irreparable. A competitive carrier that is denied a UNE when there is actual impairment is likely not remain viable because, by definition, it would be at a material cost disadvantage relative to the incumbent without cost-based access to the UNE. Further, once a carrier has been forced to exit the market, consumers are unlikely to trust that carrier to provide telecommunications services once the element in question is eventually made available as a UNE.

Arguments Against Delegation To The State Commissions. In this regard, the incumbent LECs have argued that the Commission should decline to delegate to State commissions the task of applying the general unbundling rules to the conditions applicable in particular local markets. According to the incumbent LECs, the Act prohibits such delegation and, in the alternative, that it would be poor public policy.[158] Both contentions are flawed.

First, the incumbent LECs' delegation argument is based on the belief that section 251(d)(2) requires that the Commission alone determine all the facts that will establish competitive carriers' right to obtain access to a particular unbundled network element. This is both incorrect and contrary to established precedent. Both the *Local Competition Order* and the *UNE Remand Order* expressly authorized State commissions not merely to determine if the conditions to the availability of elements that were on the national list had been satisfied in particular locales, but also to apply the Commission's "necessary and impair" standards to determine if additional network elements should be made available in their jurisdictions.[159]

This precedent is fully consistent with the Act. Section 251(d)(2) does not require the Commission to decide all the facts that are preconditions to the availability of network elements.

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[158] *See generally* 11/19/02 BellSouth/Qwest/SBC/Verizon Ex Parte.

[159] *See, e.g.*, 47 C.F.R. § 51.317.

It merely identifies the factors that the Commission must "consider" in adopting regulations to designate network elements for purposes of section 251(c)(3), and the Act's terms and structure make it explicit that the Act intends that State commissions will apply the criteria in the Commission's regulations in deciding whether particular network elements should be made available as a matter of federal law in that state.

Two separate provisions of the Communications Act make clear that State commissions have the authority to implement section 251(c)(3) in this way. First, section 252(c)(1) states that in resolving an interconnection agreement arbitration, "a State commission shall ensure that such resolution and conditions meet the requirements of section 251, including the regulations prescribed by the Commission pursuant to section 251."[160] By its express terms, this requires that State commissions make the factual determinations that establish a competitive carrier's right to obtain an element under the Commission's rules. Second, section 261(b) states that "[n]othing in this part shall be construed to prohibit any State commission from enforcing regulations prescribed prior to the date of enactment of the Telecommunications Act of 1996, or from prescribing regulations after such date of enactment, in fulfilling the requirements of this part, if such regulations are not inconsistent with the provisions of this part."[161] Because State commissions have independent authority to prescribe and to apply their own network element regulations to "fulfill the requirements" of section 251(c)(3), State commissions necessarily also have authority to apply the criteria in the regulations that the Commission adopts to the particular facts in each locale.

The Commission should also reject the claim that it would be "bad policy" to delegate specific factual determinations to State commissions. Section 252 of the Act requires that State commissions review and/or arbitrate the interconnection agreements that actually govern the unbundling rights and duties of requesting carriers and incumbent LECs, precisely because Congress recognized that States have superior knowledge of the relevant local conditions. For this same reason, the Commission has given deference to State commissions' views in determining whether BOCs have implemented arrangements that make their local markets open and thus meet the competitive checklist and public interest preconditions for a grant of long distance authority under section 271. And in light of *USTA*'s requirement that the Commission adopt unbundling rules that account for "market specific variations in competitive impairment" – and because these variations often depend on local conditions such as the level of demand served by a competitive carrier between two discrete locations and the availability of rights of way between these points – that are beyond the Commission's practical ability to assess – it is imperative that the State commissions make the basic factual determinations that will determine whether network elements must continue to be available or not.[162]

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[160] 47 U.S.C. § 252(c)(1) (emphasis added).

[161] 47 U.S.C. § 261(b).

[162] The point is underscored by the incumbent LECs' own advocacy in this proceeding. SBC's own "UNE-L cost model" shows that the cost disadvantages faced by a competitive carrier self-deploying its own switch can vary on central office-by-central office basis. *See* 1/14/03 SBC Ex Parte; 2/4/03 AT&T Ex Parte.

Arguments That The State Commission Decisions Are Preempted. Not only does sound public policy require that State commissions continue to play a significant role in opening local markets, but the law also requires it. Thus, the Commission should reject the incumbent LECs' arguments that the unbundling rules it will be adopting should set a ceiling on rules that the states may adopt pursuant to their authority under state law.[163]

Foremost, under the terms, structure, and history of the Telecommunications Act of 1996, the Commission's unbundling regulations define a national *minimum* set of network elements that competitive carriers have a federal right to obtain, and the Act expressly permits State commissions to define additional network elements under either federal or state law when they thereafter establish the interconnection agreements that actually define access rights. The provisions thus expressly adopt what the incumbents now pejoratively refer to as a "one-way ratchet," but that is the rule that generally governs the legal effect of regulations adopted by federal agencies, particularly when, as here, the governing federal statute contains express "savings" clauses that preserve States' rights to adopt supplemental regulations.

First, the only provision of the Act's local competition provision that expressly gives the Commission express authority to "preempt" state law is section 253(d). But that section only bars state laws that erect "barriers" to entry and has no application to state laws that go "too far" in granting unbundling rights.[164] Second, sections 251 and 252 of the Act clearly set up this Commission's regulations as minimum national floors that apply only if the parties *elect* to be governed by them, and they give State commissions authority to establish additional requirements under federal law in some circumstances and to establish additional obligations under state law in all circumstances.

In particular, while section 251(d) requires the Commission to adopt regulations to implement the unbundling and other requirements of section 251, the legal relationship between competitive and incumbent carriers is *not* ultimately governed by the regulations that the Commission adopts. Rather, they are governed by interconnection agreements (or statements of generally applicable terms and conditions) that are established and approved by State commissions under section 252, and State commission determinations that establish these

[163] The incumbent LECs also ask the Commission to preempt broadly change in law provisions of interconnection agreements. As AT&T has explained, the Commission has no authority to do so as this issue was not contemplated in the *Notice* issued to initiate this proceeding and because the Commission has no authority under the *Sierra-Mobile* doctrine to override the change of law provisions and to impose specific deadlines on State commissions for eliminating access to particular network elements. *See generally* 2/04/03 AT&T Ex Parte (citing 5 U.S.C. §§ 553(b) ("General notice of proposed rule making shall be published in the Federal Register …"), 551(5) (rulemaking is "agency process for formulating, amending or repealing a rule"); *Sprint Corp. v. FCC*, 2003 WL 139438, at 4-5 (D.C. Cir. Jan. 21, 2003)). Likewise, the Commission must reject the incumbent LECs' proposed re-write of the "pick-and-choose" rules as beyond the scope of the *Notice* and contrary to the plain text of the statute. *See generally* 1/29/03 AT&T Ex Parte.

[164] 47 U.S.C. §§ 253(a)&(b).

agreements are reviewable on appeal only by an appropriate federal district court, not by the Commission.[165]

Under section 252's terms, the *federal* standards that govern the establishment and approval of interconnection agreement vary, depending on whether the agreement (or a term thereof) is negotiated or arbitrated, but the same supplemental *state* law requirements apply to all agreements. If an agreement is negotiated, it is valid under federal law if its provisions are nondiscriminatory and in the public interest, and it is irrelevant whether they also meet the requirements of section 251 or of the Commission's implementing regulations.[166] If an agreement is arbitrated, State commissions must apply the "requirements of section 251, including the regulations prescribed by the Commission under section 251."[167] But whether an agreement is negotiated or arbitrated, the Act provides that a State commission can "establish[] or enforce[] other requirements of state law" in the interconnection agreements, and that the State commission's authority to apply other provisions of state law is "subject to section 253" and its ban on entry barriers – but not to any other provision of the Act. § 252(e)(3). Thus, even when Commission regulations had been invalidated on direct review by a federal court of appeals, courts have held that State commissions can impose the same or greater unbundling requirements under State law.[168]

In addition, section 251(d)(3) is entitled "Preservation of State Regulations" and specifically limits the Commission's ability to adopt regulations under § 251 that "preclude the enforcement of any regulation, order, or policy of a State." It makes explicit that state access and interconnection regulations *cannot* be preempted if they are "consistent with the requirements of this section [251]"[169] and do "not substantially prevent implementation of the requirements of this section and the purposes of this part [of the Act.]."[170] In contrast to other provisions of the Act, section 251(d)(3) measures the lawfulness of a state regulation by its consistency with *Act* and its purposes, *not* by its consistency with the Commission's regulations or policy preferences.[171]

Other provisions of the Act make it explicit that State commissions have the authority to adopt regulations to implement the requirements of section 251 of the Act so long as they are not

[165] *Id.* § 252(e)(6).

[166] *Id.* §§ 252(e)(1)(A) & 252(a)(1).

[167] *Id.* § 252(e)(1)(B).

[168] *U S WEST Communications, Inc. v. Hamilton,* 224 F.3d 1049 (9th Cir. 2000); *MCI Telecommunications Corp. v. U S WEST Communications*, 204 F.3d 1262, 1268 (9th Cir. 2000); *U S WEST Communications v. MFS Intelnet, Inc.*, 193 F.3d 1112, 1120 (9th Cir. 1999).

[169] 47 U.S.C. § 251(d)(3)(B))

[170] *Id.* § 251(d)(3)(C).

[171] *Compare id.* § 261(c) ("Nothing in this part precludes" state requirements that are "necessary to further [local] competition" as long as they are "not inconsistent with this part or the Commission's regulations to implement this part.").

inconsistent with this part of the Act. In particular, section 261(b) provides that "[n]othing in this part shall be construed to prohibit any state commission . . . from prescribing regulations . . . in fulfilling the requirements of this part [of the Act] if such regulations are not inconsistent with this part [of the Act.]"[172] Finally, the States' authority to impose additional unbundling requirements is further confirmed by the provisions of section 271. That section provides that even if unbundled switching and other facilities are not designated as network elements under sections 251(c)(3) and 251(d)(2), BOCs that obtain long distance authority must continue to offer them on an unbundled basis as *services*, and the rates for these unbundled switching and other unbundled services will be set by States whenever the services are used in connection with intrastate calls.[173] Further, to the extent de-listed elements are provided as unbundled services under interconnection agreements, State commissions will set the rates under their authority to establish and approve interconnection agreements.

The incumbent LECs' argument to the contrary is based on the Supreme Court's and the D.C. Circuit's holdings that section 251(d)(2) of the Act imposes *some* limits on the Commission's designation of network elements and does not permit the Commission to order that a network element be unbundled merely because it is technically possible to do so and because it believes "the more unbundling the better."[174] However, contrary to the incumbent LECs' implications, neither the Supreme Court nor the D.C. Circuit addressed at all the question of whether, and under what conditions, States may impose additional unbundling requirements under their expressly reserved authority. Rather, those decisions were limited solely to construing requirements which apply, by their terms, *only* to regulations that this Commission adopts and that establish minimum requirements that all State commissions must enforce in arbitrating interconnection agreements.

The incumbent LECs also rely on *USTA's* statements that unbundling imposes costs – potential adverse effects on facilities investment and transaction costs of managing a sharing regime – and that the Commission's determinations under section 251(d)(2) of the Act thus require a "balance" between the costs and benefits of unbundling.[175] The *USTA* court stated that an appropriate finding of "impairment" would automatically reflect a balancing of the competing interests,[176] and the court further stated that when unbundling is ordered *in the absence of a finding of impairment* (which the court "assume[d]" that section 252(d)(2) permits), explicit "tradeoffs" need to be made between the benefits of unbundling and its costs.[177]

It follows, the incumbents assert, that a Commission determination that certain network elements should be unbundled inherently represents a determination that greater unbundling is

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[172] *Id.* § 261(b).

[173] *See id.* § 2(b).

[174] *Iowa Utilities Bd.,* 525 U.S. at 387-92; *USTA*, 290 F.3d at 423-28.

[175] *USTA*, 290 F.3d at 425-26.

[176] *Id.* at 426-28

[177] *Id.* at 425.

harmful and represents a "national policy choice embodied in section 251(d)(2)."[178] In particular, they assert that if the Commission "excludes a UNE [*e.g.,* switching] from the unbundling list for failure to meet the federal 'impairment' standard" or otherwise, that "necessarily" represents a determination that the benefits of allowing unbundled switching does not outweigh the costs of potential adverse effects on investment in alternative facilities and that "*inclusion* of the UNE *on* the list would upset the balance" between the competing interests.[179] And the incumbent LECs urge the Commission expressly to so find and to attempt expressly to preempt additional state requirements that maintain unbundling requirements for switching or other elements that the Commission removes from the national list.[180]

But even if the Commission could on this record make such a finding, that would not mean that the State commissions would be preempted. The leading case on which the incumbents rely for the opposite is *Fidelity Fed'l Sav. & Loan Ass'n v. de la Cuesta*, 458 U.S. 141, 155 (1982), which, they assert, stands for a general rule that where a federal regulation "reflects a careful balancing of competing interests, the states may neither alter that framework nor depart from the federal judgment regarding the proper balance." In the incumbents' view, whenever a federal agency's rules represent its view as to how "congressionally mandated objectives would best be promoted" and a "reasonable accommodation of conflicting policies . . . committed to the agency's care by statute," state laws that impose additional requirements are preempted.[181]

This line of cases decisions is wholly inapposite. Each arose under a federal statute that had committed the question of how the congressional objectives should best be promoted to the federal agency, for – in sharp contrast to the provisions of the 1996 Act – these other federal schemes contained *no* savings clauses that are remotely analogous to sections 251(d)(3) and 252(e)(3). These decisions thus merely follow principles of "implied" conflict preemption that are applicable *only* when the governing federal statute does not have a relevant savings clause. For example, the federal statute at issue in *de la Cuesta* did not include *any* savings clause, let alone one that expressly precluded the agency from preempting enforcement of state regulations. Indeed, the Court there observed that "it would have been difficult for Congress to give th[at federal agency] a broader mandate" to preempt.[182] Similarly, the statute at issue in *Bethlehem Steel* did not include any savings clause, nor was there any relevant savings clause in *City of New York,* which held that the 1984 Cable Act did not deprive the Commission of its preexisting authority to adopt national technical standards. *Ray* and *Locke* both arose under the Ports and Waterways Safety Act of 1972, which contained a narrow safety clause that permitted states to

[178] 11/19/02 BellSouth/Qwest/Verizon/SBC Ex Parte at 4.

[179] *Id.* at 1.

[180] *Id.* at 1-2.

[181] *Id.* at 5-6 (*quoting Geier v. American Honda Motor Co.,* 529 U.S. 861, 871, 881 (2000); *City of New York v. FCC,* 486 U.S. 57, 64 (1988) and *citing Bethlehem Steel Co. v. New York State Labor Relations Board*, 330 U.S. 767 (1947); *United States v. Locke*, 529 U.S. 89, 111-113 (2000); *Ray* v. *Atlantic Richfield Co.*, 435 U.S. 151, 170 (1978)).

[182] *de la Cuesta*, 458 U.S. at 161.

impose higher equipment or safety standards "for [land] structures only," and which was held to create "field pre-emption" with respect to state regulation of ship design and construction. In *Geier*, the statute contained a sweeping express preemption clause invalidating any state standards that are not "identical" to DOT's safety standards and a "saving" clause providing that compliance with DOT safety standards does not "exempt" any person from liability under common law. The Court (by a vote of 5-4) reconciled these inconsistent provisions by holding that DOT safety standards would have preemptive effect in common law tort suits when, but only when, the agency regulations intended to establish a ceiling as well as a floor.[183]

Because the 1996 Act expressly preempts only state regulations creating entry *barriers*, while section 251(d)(3) expressly *saves* state unbundling regulations that do not substantially prevent implementation of the Act's requirements or purposes, it is perfectly clear that the mere fact that the Commission may strike a particular balance between competing values in adopting its unbundling rules under section 251(d)(2) *cannot* establish that state rules that adopt greater unbundling requirements are preempted. All regulations, be they state or federal, require striking a "balance" and making "tradeoffs" between costs and benefits. When there is no savings clause, the balance struck by the federal agency can be preemptive and can preclude a state from adopting greater requirements by striking a different balance. By contrast, where, as here, there is a savings clause expressly authorizing additional state regulations, the regulations that the federal agency adopts based on its view of the appropriate "balance" can do no more than establish minimum federal requirements and set a floor below which no state may go. But individual States may then exceed that floor if they make a different "tradeoff" between the competing values, or if they reasonably give weight to other factors that the federal agency did not address. Because section 251(d)(3) and section 252(e)(6) squarely establish that Congress intended to allow the enforcement and establishment of some State rules and policies that impose additional unbundling requirements, it is quite clear that the mere fact that the Commission's rules represent a "balance" cannot support the preemption of State rules imposing greater unbundling requirements simply because they strike a different balance.

Indeed, if the incumbents' contrary arguments were accepted, it would mean that the various savings clauses adopted by the 1996 Act would be nullities. But that is flatly impermissible. In one of the Supreme Court decisions on which the incumbent LECs rely – *Geier v. American Honda Motor Co.* – the Supreme Court made clear that where Congress includes an express savings clause in a statute, that clause must be construed to have independent, operative effect. In that case, the Court held that, despite the fact that the underlying statute contained a broadly worded *express* preemption clause, the Court would still construe a separate "saving provision" so that it would not be "render[ed] ineffectual" and would have substantive significance.[184] Here, the only way to give independent effect to sections 251(d)(3) and 252(e)(3) is to acknowledge that individual State commissions are free to impose additional unbundling requirements on their incumbent LECs based on their different perceptions of the appropriate tradeoffs.

[183] *Geier*, 529 U.S. at 869-870.

[184] 529 U.S. at 868, 870.

In short, whatever else Congress might have meant by the phrase "substantially prevent implementation of the requirements of this section and the purposes of this part,"[185] it could not have been the preemption of additional State unbundling requirements merely because they "strike a different balance" than the one struck by the Commission. *Every* decision to regulate, or not to regulate, strikes a "balance" between the benefits to be obtained by regulation and the costs of potentially over-regulating. For this reason, any State's decision to impose additional obligations on incumbent LECs reflects a decision to "strike" a different "trade-off" from the Commission's. If this were a sufficient basis for the Commission entirely to preclude enforcement of state regulations, section 251(d)(3) would be at war with itself.

Finally, the Commission should also decline separately to preempt State commissions from regulating the rates for elements that the Commission removes from the national list, but that the incumbents either choose to offer on an unbundled basis or are compelled to offer under other provisions of the law. The impetus for this request is the provisions of section 271 that independently require BOCs that seek and exercise long distance authority to provide access to unbundled loops, switching, transport, and signaling, whether or not these are designated as network elements that must be made available under the provisions of sections 251(c) and 252(d).[186]

Even if particular facilities are not available as *network elements* on an unbundled basis, the State commissions have authority under the state law counterparts to sections 201-205 of the Communications Act to order that use of particular facilities be offered on an unbundled basis as *intrastate services* and to set the rates for those intrastate services under whatever ratemaking method that the States deem appropriate under the applicable state law. The Supreme Court has held that the Commission cannot preempt State commissions from exercising this ratemaking authority by virtue of section 2(b) of the Communications Act,[187] and there is no provision of the 1996 Act that could possibly deprive State commissions of this authority.[188] In this regard, a State's authority to regulate rates for intrastate services applies regardless of whether it has ordered the incumbent to offer the service or whether the incumbent has done so voluntarily in order to remain in compliance with section 271 or otherwise.

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[185] 47 U.S.C. § 251(d)(3)(C).

[186] *Compare* 47 U.S.C. § 271(c)(2)(B)(ii) (requiring "access to network elements in accord with the requirements of Section 251(c) and 252(d))" *with id.*, §§ 271(c)(2)(B)(iv)(v) & (x) (requiring nondiscriminatory access to unbundled loops, unbundled transport, unbundled switching and databases and signaling). *See also id* § 160(c) (the Commission "may not forbear from enforcing requirements of Section 251(c) on 271" until they are "fully implemented").

[187] *See Louisiana Public Service Comm'n v. FCC*, 476 U.S. 355 (1986).

[188] *See Iowa Utils. Bd.*, 525 U.S. at 378 (the Commission's rulemaking authority over intrastate matters "extend[s] only to "the local competition provisions").