Jay Bennett
Executive Director-
Federal Regulatory

SBC Telecommunications, Inc.
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February 6, 2003

VIA ELECTRONIC SUBMISSION

Ms. Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street, S.W.
TW-A325-Lobby
Washington, D.C. 20554

Dear Ms. Dortch:

RE: Memorandum of Ex Parte Communication
CC Docket No. 01-338, Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers
CC Docket No. 96-98, Implementation of the Local Competition Provisions in the Telecommunications Act of 1996
CC Docket No. 98-147, Deployment of Wireline Services Offering Advanced Telecommunications Capability

Today Dr. Howard Shelanski spoke by telephone with Christopher Libertelli, Legal Advisor to Chairman Powell, on behalf of BellSouth, SBC, Qwest and Verizon. Dr. Shelanski discussed the relevance of cost disparities to impairment analysis and triggers for the elimination of unbundled switching requirements. Dr. Shelanski provided a copy of the attached letter, previously submitted in the record of this proceeding, to Mr. Libertelli.

We are submitting the original and one copy of this Memorandum to the Secretary in accordance with Section 1.12 of the Commission's rules. Please include a copy of this submission in the record of the above-listed proceedings. Also, please stamp and return the provided copy to confirm your receipt. You may contact me at (202) 326-8889 should you have any questions.

Sincerely,

/s/ Jay Bennett

Attachment

cc: C. Libertelli

Jay Bennett
Executive Director-
Federal Regulatory

SBC Telecommunications, Inc.
1401 I Street, N.W.
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Washington, D.C. 20005
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Via Electronic Submission

January 14, 2003

Memorandum of Ex Parte Communication

Ms. Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street, S.W.
TW-A325-Lobby
Washington, D.C. 20554

Dear Ms. Dortch:

Re: *CC Docket No. 01-338, Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*

CC Docket No. 96-98, Implementation of the Local Competition Provisions in the Telecommunications Act of 1996

CC Docket No. 98-147, Deployment of Wireline Services Offering Advanced Telecommunications Capability

Today Dr. Howard Shelanski sent the attached letter to Wireline Competition Bureau Chief William Maher, Jr. The letter was submitted on behalf of BellSouth, Qwest, SBC and Verizon.

We are submitting the original and one copy of this Memorandum to the Secretary in accordance with Section 1.12 of the Commission's rules. Please include a copy of this submission in the record of the above-listed proceedings. You may contact me at (202) 326-8889 should you have any questions.

Sincerely,

Jay Bennett
Attachment

cc: C. Libertelli
M. Brill
D. Gonzalez
J. Goldstein
L. Zaina
W. Maher, Jr.
J. Carlisle
S. Bergmann
R. Lerner
M.Carey
T. Navin
J. Veach
J. Miller
R. Tanner
B. Oslon
S. Wilkie
R. Pepper

January 14, 2003

William F. Maher, Chief
Wireline Competition Bureau
Federal Communications Commission
445 Twelfth Street, S.W.
Washington, D.C. 20554

Re: Response to WorldCom's January 8, 2003 *Ex Parte* filing

Dear Mr. Maher:

This letter makes two broad points in response to WorldCom's ex parte filing of January 8, 2003 on the cost of serving residential customers over UNE loops. In its filing WorldCom argues that it will in many cases be "impaired" by the substitution of UNE-L for UNE-P because under UNE-L it will be at a cost disadvantage to the ILECs. I do not here address the details or mechanics of the calculations that WorldCom submits in support of its contention. My purpose is to address two fundamental concerns with WorldCom's argument. First, and most importantly, WorldCom offers no theory of "impairment" beyond implicitly equating it with any disparity in costs. WorldCom's premise therefore appears to be that CLECs should be considered "impaired" any time ILECs have demonstrable cost advantages over new entrants. That premise is incorrect, as I will discuss below. Second, even to the extent cost disparities are relevant to the Commission's impairment analysis, WorldCom's analysis does not do the comparisons necessary to demonstrate the scale or scope of any such disparities.

Cost differences do not in themselves necessarily constitute impairment

Cost disparities are common, if not the norm, among competing businesses. Firms that vie for customers in most markets differ in their scale, scope, efficiency, and investment strategies. New entrants, in particular, will almost always have to incur costs that incumbents no longer face. Few businesses involve only short run, variable costs without any fixed or sunk costs. Yet new competitors enter many industries viably and successfully even though they lack cost parity with incumbents. It would be a weak and economically meaningless definition of impairment that hinged on such normal and ultimately non-determinative cost differences. New entrants often survive and thrive despite cost disadvantages because they have offsetting comparative advantages that help them over the long run; because the industry structure permits positive margins even for firms with comparatively higher costs; because demand is heterogeneous such that they find sufficient numbers of customers even though their product or service might not be identical in price/quality to incumbents' product or service; and/or because initial cost disparities may erode over time.

Consider the first of the above factors. A new firm can make technological and other strategic decisions with less constraint than an incumbent can. This is true even, as in local exchange service, if the entrant uses part of the incumbent's existing infrastructure. The entrant can pick and choose which markets to enter, which customers to target within those markets, and to some degree which kinds of technological inputs to use in serving those customers. The less the new entrant relies on the incumbent's facilities, the greater the entrants' freedom to choose new, incrementally more efficient inputs and system architectures to provide competing service. That the entrant must incur some costs that the incumbent does not or has short run costs that are initially higher than the incumbent's does not mean that the entrant is at an overall or long-run disadvantage to the incumbent. The Commission has in the past clearly recognized this point. In its 1991 AT&T Streamlining Order the Commission stated the following:

> "Some parties argue that AT&T enjoys market power by virtue of its size and superior resources, financial strength, and technical capabilities. Any such advantages that AT&T may have, however, do not necessarily confer market power. The issue is not whether AT&T has advantages, but, if so, why, and whether any such advantages are so great as to preclude the effective functioning of a competitive market. An incumbent firm in virtually any market will have certain advantages -- including, perhaps, resource advantages, scale economies, established relationships with suppliers, ready access to capital, etc. Such advantages do not, however, mean that these markets are not competitive, nor do they mean that it is appropriate for government regulators to deny the incumbent the efficiencies its size confers in order to make it easier for others to compete. Indeed, the competitive process itself is largely about trying to develop one's own advantages, and all firms need not be equal in all respects for this process to work." 6 FCC Rcd 5880 (1991) at para. 60.

Precisely the same reasoning applies in this context and to the Commission's determination of what constitutes impairment. The simple fact of cost disparities, cannot, as WorldCom implies in its filing, suffice to show economic impairment. This point has more recently been emphasized by the United States Court of Appeals in *United States Telecom Ass'n v. FCC*, 290 F.3d 415, 426-427 (D.C. Cir. 2002) (*USTA v. FCC*) (finding that impairment cannot be based on the kinds of cost disparities usually faced by new entrants in a given sector of the economy).

It is important to note that cost disparities do not necessarily take on additional significance just because some of the asymmetries relate to sunk costs or to scale economies. WorldCom argues that sunk costs create barriers to entry and are thus particularly impairing. It is certainly true, as WorldCom argues, that the higher the sunk costs the greater the risk of entry into a market. Yet exit from a market is rarely costless and the risk of stranding costs is a normal part of business in most industries. In fact, it is a risk that incumbents face as well. WorldCom nonetheless appears to believe that any sunk cost for a new entrant constitutes impairment. Indeed, in footnote 10 of its filing WorldCom suggests that even where a piece of equipment can be redeployed, there is impairment because the costs of initially installing the equipment cannot be recovered. But these are clearly the kind of normal set-up costs that new firms incur all the time. To recognize such costs as "impairment" simply because they are sunk does not make economic sense.

Similarly, the existence of scale advantages for the incumbent does not necessarily create meaningful impairment for new competitors. The Commission recognized as much in the above-quoted excerpt from its 1991 AT&T streamlining order, as did the Court of Appeals in *USTA v. FCC*.

See 290 F.3d at 427. To be sure, scale economies may become so substantial that they make competition practically impossible, as in the case of natural monopoly. But, again, new entrants will often if not usually be at a scale disadvantage to incumbents and scale disparities over even a large range need not pose a substantial or long-term barrier to entry. The mere fact that an entrant might not, for example, initially be able to deploy a switch as efficiently as an ILEC is to be expected and cannot in itself prove material "impairment."

In the end, WorldCom's filing ignores the many reasons why cost differences alone do not constitute competitive impairment. Their premise that the Commission must set policy so as to eliminate any disadvantages for CLECs in cost or service quality is, as an economic matter, empirically and theoretically incorrect. It has moreover been rejected by the Supreme Court. The Commission had originally found, in paragraph 285 of the 1996 Local Competition Order, that impairment exists if the quality of the service the entrant can offer, absent access to the requested element, declines and/or the cost of providing the service rises. The Supreme Court specifically rejected the Commission's statement and explained that "[i]n a world of perfect competition, in which all carriers are providing their service at marginal cost, the Commission's total equating of increased cost (or decreased quality) with "necessity " and "impairment" might be reasonable; but it has not established the existence of such an ideal world." 525 U.S. at 389-90. To the extent WorldCom here again argues that any cost disparity or service disadvantage constitutes impairment, the Commission must reject WorldCom's premise.

Even where cost differences do matter, WorldCom does not provide the necessary analysis to demonstrate such differences

WorldCom bases its case with an economic analysis purporting to show that under a UNE-L regime ILECs will have lower costs than CLECs. It bears emphasizing that, as an economic matter, cost comparisons are only one aspect of any meaningful examination of competitive impairment, which would focus more broadly on whether markets are contestable. WorldCom's submission does not address the evidence that local markets are not only contestable, but actually contested. WorldCom's impairment analysis focuses solely on comparing estimated CLEC costs under UNE-L with estimated ILEC costs, for which the model uses UNE-P rates as a proxy. But even if such a cost comparison, standing alone, were appropriate to evaluate impairment, WorldCom's version of that comparison is not helpful. WorldCom's calculation by definition does not incorporate any real-world ILEC operating costs or even any estimates of such costs. It instead incorporates proxy costs generated by a model of a hypothetical, rather than real, network.

WorldCom argues that its analysis is conservative because the TELRIC rates it uses to proxy ILEC costs are higher than the ILEC costs generated by the HAI model WorldCom uses to measure its own costs. Yet it is possible for a model (or different models) to proxy one carrier's costs well and another's poorly. More importantly, WorldCom cannot deny that TELRIC is a hypothetical network model that specifically eschews measurements of an ILEC's real-world operating costs. Indeed, that hypothetical nature of TELRIC was the central issue in *Verizon v. FCC*, in which the Supreme Court upheld TELRIC pricing. Once that hypothetical nature of TELRIC is acknowledged, then WorldCom's economic analysis becomes irrelevant to the question of impairment. There is nothing conservative about comparing one hypothetical model with another if an ILEC's real costs are in fact much higher than TELRIC prices for UNE-P. And one would be hard pressed to assume a correspondence between an ILEC's operating costs and UNE-P prices given the great differences in the latter that exist across jurisdictions. Yet actual competitive impairment depends on actual market factors, including issues relating to actual ILEC costs and actual CLEC costs. WorldCom's model addresses neither.

WorldCom devotes much of its analysis to arguing that UNE-L would impose higher costs than UNE-P on CLECs. Only by the circular logic of equating UNE-P with ILEC costs, and moreover by ignoring actual empirical evidence of entry by means other than UNE-P, does that comparison possibly say anything about competitive impairment. WorldCom never undertakes another calculation that would be useful to making competitive predictions: whether, under current retail rates, UNE-L would provide positive margins for CLECs. WorldCom's implicit answer is that current retail rates do not matter because the ILEC will use its alleged cost advantage to lower retail prices. But even if one assumes a material cost disparity to exist, one cannot simply assume the real-world feasibility of downward pricing by the ILECs, especially in the residential context to which WorldCom restricts its analysis. Indeed, such assumptions of downward pricing responses are particularly unwarranted where they are based on a TELRIC proxy that likely understates ILEC costs and therefore overstates the margins available to be decreased.

Respectfully submitted

/s/ Howard A. Shelanski
Howard A. Shelanski