

**Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554**

In the Matter of)	
)	
AT&T Corp.)	RM No. 10593
)	
Petition for Rulemaking to Reform)	
Regulation of Incumbent Local Exchange)	
Carrier Rates for Interstate Special)	
Access Services)	

**Declaration of
Alfred E. Kahn and William E. Taylor
On Behalf of
BellSouth Corporation, Qwest Corporation, SBC Communications, Inc., and
Verizon**

SUMMARY

Competition in the special access market is vigorous and growing. Even in an environment in which RBOC local service volumes are declining and market valuations of telecommunications firms have collapsed, local exchange competition and competition for special access services continue to expand. Retraction of pricing flexibility for RBOC special access services as AT&T demands is not only unnecessary; it would weaken competition.

In contrast to AT&T's litany of familiar complaints about the prematurity of pricing flexibility and its dependence on RBOC facilities and services, we observe that the competitive supply of special access services has steadily increased with no observable slowdown from the implementation of limited special access pricing flexibility in 2001 and 2002. Competitive fiber route miles roughly doubled each year between 1990 and 1995, increasing from about 500 route miles to about 21,000, and current estimates put CLEC fiber networks at approximately 100,000 route miles in 1999 and 184,000 in 2002. Geographic coverage increased correspondingly; there are now

nearly 2,000 CAP networks in the largest 150 MSAs, and the top 25 MSAs average over 32 CLEC networks in *each*. Several independent estimates put the current CLEC share of special access revenues—not including the very large extent to which such CLECs as WorldCom and AT&T supply their own needs—at approximately 30 percent, and that share has continued to increase since the RBOCs were permitted flexibility in pricing of these special access services. On the retail side, the three largest IXCs still dominate the market for large business customers (the “enterprise business market”), which is the largest retail market that uses special access as an input. That fact demonstrates that IXCs can successfully compete in one of the most competitive retail markets, relying on some combination of self-supply, competitive supply and RBOC supply of the requisite special access facilities.

The principal putative facts that AT&T cites in support of its complaint center around the level and growth of RBOC special access rates of return and price-cost margins. Rates of return for individual services based on fully distributed costs are, however, notoriously meaningless as measures of anything, a fact upon which we and AT&T’s economists have, until now, been in complete agreement. Similarly, price-cost margins measured using TELRIC are not evidence of market power: blank-slate TELRIC does not approximate RBOC forward-looking incremental costs and even properly-calculated price-cost margins need not be small in competitive markets where fixed and common costs are important, as they undoubtedly are in the telecommunications market. Indeed, evidence from AT&T’s pricing of long distance service three years after it was granted full pricing flexibility shows margins as large or larger than those of which it complains here. Finally, the facts contradict AT&T’s theories. The RBOCs’ average revenue per line between 1996 and 2001 decreased by more than 1 percent per year in nominal terms and by more than 3 percent per year in constant dollars. Over the same period, trouble reports per access line fell, and the percentage of installation order commitments met remained consistently high. Nothing in the data remotely suggests the exercise of market power, whether by increasing prices or allowing service quality to deteriorate.

This is no evidence on which to reverse the Commission’s long-standing policy of adapting regulatory constraints to the degree of competition in the market. Reducing the

RBOCs' ability to price services flexibly in markets where competitors have already constructed facilities and incurred sunk costs would only hamstring one of the larger participants in the market and deny customers—wholesale and retail—the benefits of vigorous competition.

**Declaration of
Alfred E. Kahn and William E. Taylor
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I. Qualifications

My name is Alfred E. Kahn. My business address is 308 N. Cayuga Street, Ithaca, NY 14850. I am the Robert Julius Thorne Professor of Political Economy, Emeritus, Cornell University and Special Consultant with National Economic Research Associates, Inc. (NERA). I received my A.B. degree summa cum laude from New York University and my Ph.D. from Yale University, in 1942. I came to Cornell University in 1947 and have served successively as Chairman of the Department of Economics and Dean of the College of Arts and Sciences. I have been Chairman of the New York State Public Service Commission and of the (U.S.) Civil Aeronautics Board; and in my capacity as Advisor to President Carter on Inflation, I participated actively in the successful efforts of his Administration to deregulate the trucking industry.

I am the co-author of *Fair Competition, The Law and Economics of Antitrust Policy*, author of the two-volume *The Economics of Regulation*, reprinted in 1988 by MIT Press, *Letting Go: Deregulating the Process of Deregulation*, published in 1998 by Michigan State University Institute of Public Utilities, *Whom the Gods Would Destroy or How Not to Deregulate*, published last year by the AEI-Brookings Joint Center for Regulatory Studies, and have published and testified extensively over the last twenty years in the area of direct economic regulation and deregulation, and on the requisites of efficient competition in regulated and previously regulated industries. I served as Associate Economist with the Antitrust Division of the U.S. Department of Justice in 1941-42; as a member of AT&T's Economic Advisory Board in 1968-74; was a member of the Attorney General's National Committee to Study the Antitrust Laws and the National Commission on Antitrust Laws and Procedures in the Eisenhower and Carter Administrations, respectively; I have served as consultant with both the Antitrust Division of the Department of Justice and the Federal Trade Commission; I was recently

a member of the National Research Council – Transportation Research Board committee charged with reporting to Congress on the state of competition in the airline industry.

My name is William E. Taylor. I am Senior Vice President of National Economic Research Associates, Inc., head of its Communications Practice, and head of its Cambridge office located at One Main Street, Cambridge, Massachusetts 02142.

I have been an economist for over twenty-five years. I earned a Bachelor of Arts degree from Harvard College in 1968, a Master of Arts degree in Statistics from the University of California at Berkeley in 1970, and a Ph.D. from Berkeley in 1974, specializing in Industrial Organization and Econometrics. For the past twenty-five years, I have taught and published research in the areas of microeconomics, theoretical and applied econometrics and telecommunications policy at academic and research institutions including the Economics Departments of Cornell University, the Catholic University of Louvain in Belgium, and the Massachusetts Institute of Technology. I have also conducted research at Bell Laboratories and Bell Communications Research, Inc. I have appeared before state and federal legislatures, testified in state and federal courts, and participated in telecommunications regulatory proceedings before state public utility commissions, as well as the Canadian Radio-television Telecommunications Commission, the Mexican Federal Telecommunications Commission and the New Zealand Commerce Commission. I have also filed studies before the Federal Communications Commission on numerous occasions. Of particular relevance to the present docket were a series of five filings with Professor Richard Schmalensee between 1994 and 1998 in CC Docket Nos. 94-1 and 96-262 on the use of observable triggers to determine when markets were sufficiently competitive to warrant pricing flexibility and the application of those triggers to special access markets.

II. The Special Access Market Remains Vigorously Competitive.

Special access services are private line services, i.e., services or facilities dedicated to a single customer. Special access channel terminations are sold to long distance carriers (“IXCs”) to originate or terminate interstate networks generally built for large business customers, and special access transport to connect the IXCs’ or CLECs’ points of presence (“POPs”) with the local exchange carrier’s central offices. Special

access services are also sold directly to large business customers, typically as part of private networks.

A. Competition in the special access market is well-developed.

Competition for special access services is as old as the RBOCs. Taking advantage of the regulatorily-imposed markups above marginal or book costs incorporated in RBOC interstate and intrastate carrier access charges, as a contribution to recovery of fixed and common costs, including the deliberate subsidization of basic residential charges, Teleport (TCG) began providing bypass services to IXC and business customers in lower Manhattan in 1984, shortly after the divestiture of the Bell System. Additional entry and expansion followed rapidly, as Institutional Communications Company (ICC) entered the Washington, DC market in 1986 and Chicago Fiber Optic followed shortly with an optical fiber network in Chicago. Between 1984 and 1992, competitive access providers (“CAPs”) proliferated, constructing fiber rings in the business districts of large and medium-sized cities, primarily providing dedicated connections between large business customers and their IXCs in order to avoid the regulated carrier access charges. In 1992, incumbent LECs were required to provide collocation in their central offices to CAPs, and CAP networks responded by building facilities between IXC POPs and collocation facilities in LEC central offices, opening the market for transport to competition.¹

Demand for CAP services grew rapidly. CAP fiber route miles roughly doubled each year between 1990 and 1995, increasing from about 500 route miles to about 21,000, and current estimates of CLEC fiber networks total approximately 100,000 route miles in 1999 and 184,000 in 2002. Geographic coverage increased correspondingly; there are now nearly 1,800 CAP networks in the largest 150 MSAs, and the top 25 MSAs average over 32 CLEC networks in *each*.² Independent sources put the current CLEC share of special access revenues at more than 30 percent, and that share has continued to

¹ See “Competition For Special Access Services” filed as Attachment B to Opposition of Verizon in this proceeding on December 2, 2002 (“2002 Special Access Fact Report”) at 7.

² 2002 Special Access Fact Report at 12-13.

increase since the RBOCs were permitted flexibility in pricing of these special access services.³

On the retail side, the three largest IXCs still dominate the market for large business customers (the “enterprise business market”), which is the largest retail market that uses special access as an input. That fact demonstrates that IXCs can successfully compete in one of the most competitive retail markets, relying on some combination of their own special access facilities and those of the other competitive suppliers and the RBOCs.

B. The FCC’s triggers for pricing flexibility are reasonable and have been successful in application.

Against this background of established and proliferating facilities-based competition, the FCC embarked on a measured transition path towards pricing freedom for special access services as competition developed. Upon divestiture, LECs were permitted limited pricing flexibility in the form of optional volume discounts for private line and special access services, in recognition of the growing competition for those services.⁴ In transitioning to price cap regulation in 1990, the FCC authorized additional flexibility in the form of relaxed pricing rules in the special access basket, and those rules were gradually loosened over the next five years, permitting more extensive term and volume discounts and prices deaveraged by density zone.⁵ After the Telecommunications Act of 1996 opened the local and long distance markets to additional competition, the FCC reassessed the special access pricing rules, and in August 1999 adopted the Fifth Report and Order in CC Docket No. 96-262, which outlined circumstances under which suppliers of price-cap-regulated access services would be permitted additional pricing flexibility. The intention of the Order was to

allow[] competition rather than regulation, to determine prices for interstate access services, thus providing customers more choices among services, carriers, and rates. The Order gives the nation’s largest telephone companies progressively greater flexibility in setting interstate

³ 2002 Special Access Fact Report at 27-28.

⁴ Report and Order, *Private Line Structure and Volume Discount Practices*, 97 FCC 2d 923 ¶39 (1984).

⁵ Second Report and Order, *Policy and Rules Concerning Rates for Dominant Carriers*, 5 FCC Rcd 6786 (1990) and First Report and Order, *Price Cap Performance Review for Local Exchange Carriers*, 10 FCC Rcd 8961 (1995).

rates as competition develops, gradually replacing regulation with competition as the primary means of setting prices.⁶

Among other reforms, the Order established a two-phased framework for granting specific forms of pricing flexibility, along with objective triggers that measured the degree to which competition had developed in specific geographic markets. In general, if competitors have collocated and use competitive transport in a target percentage of a price cap LEC's wire centers (or wire centers accounting for a target percentage of the LEC's revenue) in an MSA, the LEC's special access services are entitled to either Phase I or Phase II relief, depending on the trigger attained.

Phase I relief permitted the LEC to offer contract tariffs and volume and term discounts on one day's notice; Phase II relief removed the price caps entirely. More stringent triggers were set for obtaining Phase II relief than for Phase I and for relief applying to channel terminations than to transport. Beginning in the Fall of 2000, the LECs applied for such flexibility, and the first petitions were granted in December.⁷ Additional petitions followed in 2001 and 2002.

These rules represent a reasoned and measured transition from a regime in which regulation constrains prices towards one in which prices are constrained only by competitive forces. Properly, they tailor the degree of pricing flexibility to the geographic differences in the rate at which CAPs, IXC's and CLEC's invest and build their own competitive facilities—specifically, to the proportion of wire centers in an MSA in which competitors have made sunk investments in their own facilities.⁸ The presence of such investments indicates the need for pricing flexibility because it shows that—in the wire center in question—the market is open and entry barriers are sufficiently low that some firms are actually investing in sunk assets. Such committed entry is also a powerful deterrent to anticompetitive pricing by incumbent LEC's because, once installed, the facilities would remain even if the original owner could be driven from the market.

⁶ FCC News, Report No. 99-33, "Commission Adopts Pricing Flexibility and Other Access Charge Reforms," August 5, 1999.

⁷ BellSouth Petition for Pricing Flexibility for Special Access and Dedicated Transport Services, CCB/CPD No. 00-20, Memorandum Opinion and Order, 15 FCC Rcd 24588, (Dec. 15, 2000).

⁸ In fact, the FCC's triggers underestimate the amount of sunk competitive investment in each wire center because they focus on collocation and ignore investment and competition that makes no use of RBOC facilities at all!

The Commission explicitly expounded the economic logic in its decision. Competitors who collocated in a wire center almost always constructed transmission facilities that terminated in the collocation cage.⁹ Once competitors had made such irreversible investments, there was no need for protection against possible ILEC anticompetitive pricing because it was unlikely to succeed.¹⁰ Entry in one wire center in an MSA was an effective trigger for competition throughout the MSA because carriers enter the market on an MSA basis and special access customers are large, sophisticated businesses with bargaining power sufficient to prevent the exercise of ILEC market power in parts of the MSA in which competitive facilities are absent.¹¹ Moreover, the effect of using collocation as the trigger mechanism was likely to be conservative because it ignored the presence of competitors that completely bypassed the ILECs' facilities.¹²

III. AT&T Offers No Valid Evidence of Excessive ILEC Market Power or Insufficiently Effective Competition.

AT&T provides no valid economic evidence that RBOCs retain significant market power in special access markets. Its use of accounting profit rates as we will proceed to explain, based on fully distributed costs to demonstrate that individual services are

⁹ "the presence of an operational collocation arrangement in a wire center almost always implied that a competitor has installed transmission facilities to compete with the incumbent," Fifth Report And Order And Further Notice Of Proposed Rulemaking, CC Docket Nos. 96-262, 94-1, 98-63 and 98-157, released: August 27, 1999 ("Fifth Report and Order") at ¶82.

¹⁰ "Phase I of our pricing flexibility framework provides incumbent LECs with regulatory relief when competitors have made irreversible investments in facilities within a given MSA. At that point, we no longer need to protect competition from exclusionary pricing behavior by incumbent LECs, because efforts to exclude competitors are unlikely to succeed" Fifth Report and Order at ¶77.

¹¹ "...regulatory relief is warranted ... even though such relief might lead to higher rates for access to some parts of an MSA that lack a competitive alternative, for several reasons. First, the customers for the services we address in this section are IXCs and large businesses, not residential or small business end users. These large and sophisticated customers generate significant revenues for the incumbent and are not without bargaining power with respect to the incumbent. Second, delaying Phase II regulatory relief until access customers have a competitive alternative for access to each and every end user might give competitors the ability to "game the system." In other words, competitors might be able to prevent an incumbent from obtaining pricing flexibility in an MSA simply by choosing not to enter certain parts of that MSA or to serve certain customers. We will not distort the operation of the market in this manner. Finally, because regulation is not an exact science, we cannot time the grant of regulatory relief to coincide precisely with the advent of competitive alternatives for access to each individual end user. We conclude that the costs of delaying regulatory relief outweigh the potential costs of granting it before IXCs have a competitive alternative for each and every end user." Fifth Report and Order at ¶¶142-144.

¹² "evidence of collocation may underestimate the extent of competitive facilities within a wire center, because it fails to account for the presence of competitors that do not use collocation and have wholly bypassed incumbent LEC facilities" Fifth Report and Order at ¶95.

overpriced is economic nonsense. Similarly, inferring the presence of market power from price-cost margins—particularly where the cost measure employed is TELRIC—has no valid economic basis. Finally, AT&T’s claim that increases in special access prices and revenues imply the absence of competitive alternatives for customers is incorrect as a matter of both fact and principle.

A. Earnings derived from measures of fully allocated costs cannot be used to justify a reduction in pricing flexibility.

AT&T says that high accounting rates of return for RBOC interstate special access services “represent conclusive proof of the Bells’ overwhelming market power.”¹³ This is a truly outrageous claim, relying as it does on measures of fully allocated book costs of services whose production in common with others entails a very high proportion of fixed and common costs and significant economies of scope—all the more so coming from a company and specific witnesses who have consistently and correctly decried the basis for such claims in economic terms for many decades. Yet, in this case, Drs. Ordover and Willig surprisingly, without comment, equate ARMIS regulated rates of return for special access with economic profits (at ¶24), even adjusting them upward on the ground that “the RBOCs’ true costs of providing services over their local networks are their much lower forward-looking economic costs” (at ¶26) and by so doing enjoying the best of both possible worlds—regulatory allocations of costs themselves lower than regulatory costs, as typically measured.

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

¹³ AT&T Corp., Petition for Rulemaking To reform Regulation of Incumbent Local Exchange Carrier Rates For Interstate Special Access Services, RM 10593, October 15, 2002 (“Petition”), at 8.

Indeed, AT&T presented this very argument to regulators in Massachusetts when requesting to be relieved of rate of return regulation for intrastate services:

AT&T is an integrated, multijurisdictional company providing telecommunications services worldwide using an integrated national management structure and employing the same physical and human resources to provide international, interstate and intrastate services. Because AT&T's services used the same network, computers and other facilities whatever the jurisdiction, determining a cost basis for calculating an economically meaningful rate of return is impossible. Rationally determining the cost basis for purposes of pricing individual state subsets of those services is also an economically impossible task. Yet, Massachusetts ROR regulation requires that a fully-allocated cost basis be established and that the prices for AT&T's intrastate services be modified to reflect such cost allocations. Allocating AT&T's multistate costs to determine AT&T's Massachusetts costs, further allocating those costs between interstate and intrastate services, and yet further allocating the intrastate costs among numerous intrastate services is economically irrational as a basis for setting prices. There is no rational basis for believing that rates based on fully allocated costs are either fair or economically justified.¹⁴

The same considerations that led AT&T to contend that rates of return based on allocated accounting costs are “economically irrational” as a basis for pricing apply equally to RBOC interstate special access. The allocations of RBOC accounting costs between regulated and unregulated intrastate and interstate services are, of necessity, not based on cost-causation. Among interstate services, the allocation of costs to special access services requires additional, similarly arbitrary assumptions. The sources of these difficulties are obvious. Fixed and common costs permeate—indeed dominate—a telephone company's cost structure: to offer a single example, Executive and Planning plus General and Administrative Expenses represents more than 11 percent of Total Operating Expenses for the RBOCs.¹⁵ Even more important, each RBOC's network provides interstate and intrastate services, carrier services (special and switched access) and retail services (local and toll): a large fraction of these network costs cannot be assigned on a cost-causal basis to individual services.

¹⁴ Initial Brief of AT&T Communications of New England, Inc., dated April 23, 1992, in the Commonwealth of Massachusetts Department of Public Utilities proceeding DPU 91-79, at 42-43. Citations omitted.

¹⁵ In the 2001 RBOC ARMIS 43-02 report, the relevant expenses accounts are Executive and Planning (6710), General & Administrative (6720) and Total Operating Expenses (720).

The regulatory expedient of assigning fixed costs among categories (e.g., between regulated and unregulated or between interstate and intrastate jurisdictions), in proportion to variable costs or demand volumes, though “reasonable,” is not cost-causative, and the resulting costs are not economic costs. It might be equally reasonable to allocate railroad overhead costs to services by volume, weight or value, but shippers of feathers, coal and diamonds would undoubtedly disagree about the results. In Dr. Willig’s prophetic words some 15 years ago,

Fully allocated cost figures and the corresponding rate of return numbers simply have zero economic content. They cannot pretend to constitute approximations to *anything*. The “reasonableness” of the basis of allocation selected makes absolutely no difference except to the success of the advocates of the figures in deluding others (and perhaps themselves) about the defensibility of the numbers. There just can be no excuse for continued use of such an essentially random, or, rather, fully manipulable calculation process as a basis for vital economic decisions by regulators.¹⁶

B. Margins between price and incremental cost are not a measure of market power for telecommunications services.

AT&T asserts (Petition at 10) that the markup above incremental costs for special access services is unreasonable and much higher than markups in competitive markets.¹⁷

Special access services are provided over the same facilities and are functionally equivalent to high capacity loop and transport network elements. Yet, the Bell’s month-to-month special access rates are generally double...their comparable UNE rates.¹⁸

Both the comparison and the inference drawn from it are absurd.

First, where margins between price and incremental cost are used to measure anything, the incremental cost in question is emphatically never TELRIC. For example, the familiar Lerner index (the percentage markup of price above incremental cost) is sometimes calculated for a firm, but the incremental cost in question is the forward-looking economic cost of the firm itself, not the hypothetical cost of a perfectly efficient

¹⁶ W. J. Baumol, M. F. Koehn and R.D. Willig, “How Arbitrary is ‘Arbitrary’? – or, Toward the Deserved Demise of Full Cost Allocation,” *Public Utilities Fortnightly*, Vol. 120, No. 5, September 3, 1987 at 21.

¹⁷ Also see the Declaration of Janusz A. Ordovery and Robert D. Willig on Behalf of AT&T Corp. filed as Tab B to the Petition. (“O-W Declaration”) at 12.

firm serving the entire market as a wholesale provider using a fully-modern network optimally deployed around the incumbent firm's existing switch locations. Second and more fundamentally, price markups above incremental cost are necessary in an industry like telecommunications that is characterized by a large proportion of shared and common costs, fixed and variable. It is well-understood in the industry that it is not possible to price each telecommunications service at incremental costs and still have a viable firm that can expect to recover all of its forward-looking costs.

Experience from other segments of the industry clearly demonstrates that in the face of significant fixed and common costs, prices systematically exceed marginal costs. For example, the domestic residential long-distance telecommunications market has often been considered to be reasonably competitive, and AT&T was declared to be nondominant in that market by the FCC in 1995. Three years later, margins in that market were, however, as large or larger than those cited as "obscene" by AT&T (Petition at 3) for RBOC special access margins today—three years after they were accorded more limited flexibility.

For July 1998, using a public database of telephone bills of a random sample of U.S. residential households, we measured the average rate per minute actually paid by AT&T's customers for interstate domestic direct-dial phone calls, including a per-minute assignment of service charges, promotional credits, fixed monthly PICC flow-through charges, and a fixed monthly universal service fund assessment.¹⁹ From this sample, the average rate paid by AT&T residential customers was about 20 cents per conversation minute. Switched interstate access charges were about 2.8 cents per conversation minute in July 1998.²⁰ We have estimated that, at that time, federal universal service fund assessments and the Primary Interexchange Carrier Charge ("PICC") paid by AT&T to

¹⁸ Petition at 10 and O-W Declaration at 12. It is unclear whether to attribute this opinion to AT&T or to its independent economic experts, because—except for a typographic error in the AT&T Petition—they appear identically and without attribution in both the Petition and the O-W Declaration.

¹⁹ W. Taylor and P. Brandon, "Assessment of AT&T's Study of Access Charge Pass-Through," study of long distance pricing, filed ex parte on behalf of the United States Telephone Association, (CC Docket No. 96-262), October 22, 1998 ("Taylor-Brandon"). These calculations use residential billing data from *MarketShare Monitor*TM, *op. cit.* They allocate domestic direct-dialed calling-plan subscription charges, service charges, and promotional credits between interstate and intrastate direct-dialed calls. The PICC and universal service charges are interstate.

²⁰ Taylor-Brandon, and Federal Communications Commission, "Universal Service Monitoring Report", CC Docket No. 98-202 (September 2000), Table 7.15.

serve its residential customers, when added to access charges, came to about 6 cents per conversation minute.²¹ Estimates of long distance network marginal cost vary between 1 and 2 cents per conversation minute and total about 5 cents per minute if one includes marketing expenses.²² Combining these estimates, AT&T's marginal costs of serving residential customers totaled 7 to 11 cents per conversation minute, depending on whether one includes marketing expenses. Thus, AT&T's margin from residential customers was at least 9 cents per minute, even if one includes marketing expenses ($20 - 11 = 9$), and uses the upper range of estimated network costs. Thus three years after receiving considerably more pricing flexibility than the RBOCs received three years ago, AT&T, in the residential long-distance market that is frequently asserted to be competitive, appears to have imposed a minimum markup of almost 82 percent (9 relative to 11 cents) or a markup of more than 185 percent if marketing costs are not treated as incremental.

The point of this example is that in industries, such as telecommunications, characterized by high fixed costs and economies of scale and scope, it is neither uncommon nor in itself incompatible with effective (but sustainable) competition to find high percentage mark-ups of price above incremental cost for individual services. The case made by Drs. Baumol, Panzar and Willig for the importance of contestability as a measure of the effectiveness of competition rests precisely on the inapplicability of the pure or perfect competition model, in which alone there can be no such markups.²³

²¹ In July 1998, the residential PICC was \$0.95 for the first line and \$1.77 for each additional line. *See id.*, Table 7.14. The universal service fund ("USF") assessment was 3.93 percent. *See* Federal Communications Commission, Public Notice, *Proposed Third Quarter 1999 Universal Service Contribution Factors*, CC Docket No. 96-45, DA 99-1091, June 4, 1999. We have calculated AT&T's average cost of the PICC and USF per minute of serving its residential customers using a sample of residential bills from Market Facts, Inc. and PNR and Associates, Inc., *MarketShare Monitor*TM (September 9, 1998).

²² Estimates of toll and access incremental costs are presented in Robert W. Crandall, *After the Breakup: U.S. Telecommunications in a More Competitive Era* (Washington D.C.: The Brookings Institution, 1991), at 138-141; Lewis J. Perl and Jonathan Falk, "The Use of Econometric Analysis in Estimating Marginal Cost," Presented at Bellcore and Bell Canada Industry Forum, San Diego, California (April 6, 1989), Table 2; Robert W. Crandall and Leonard Waverman, *Talk is Cheap: The Promise of Regulatory Reform in North American Telecommunications* (Washington D.C.: The Brookings Institution, 1996); and Paul W. MacAvoy, *The Failure of Antitrust and Regulation to Establish Competition in Long-Distance Telephone Services* (Cambridge, Massachusetts: The MIT Press and Washington D.C.: The AEI Press, 1996). The costs are obviously averages and vary a great deal across jurisdictions, times of day and technologies.

²³ W.J. Baumol, J.C. Panzar and R.D. Willig, *Contestable Markets and the Theory of Industry Structure*, San Diego: Harcourt Brace Jovanovich, 1982.

Thus, such markups in the special access market three years after limited pricing flexibility began are not in themselves evidence of excessive prices or of the presence of market power.

C. AT&T misinterprets demand, price and revenue changes in the special access market.

In both its Petition (at 11) and O-W Declaration (at ¶33), AT&T infers that RBOCs possess market power for special access services from its claim that the special access price increases (cited in Mr. Stith's Declaration) have led to higher revenues. While RBOC special access revenues have indeed increased, the reason is not inelasticity of demand but simply rapid growth in the demand for such circuits. The same ARMIS data sources that Mr. Friedlander uses readily show that special access volumes, measured by the sum of analog and digital access lines, have increased rapidly throughout the late 1990s, while RBOC special access revenue per circuit has declined, not increased.

These data clearly show a rapid and accelerating growth of RBOC special access lines, averaging 30 percent per year over the 1996-2001 period, which is consistent with the conventional industry wisdom that data services have been growing much faster than voice services in recent years.²⁴ Other sources show comparable growth rates for both ILECs and CLECs in the special access market: revenues grew at an annual rate of approximately 36 percent for both between year-end 1999 and year-end 2000,²⁵ CLEC fiber network route miles increased by about 84 percent between 1999 and 2002²⁶ and comparable expansion was experienced in the number of CLEC networks serving the largest 150 MSAs.²⁷

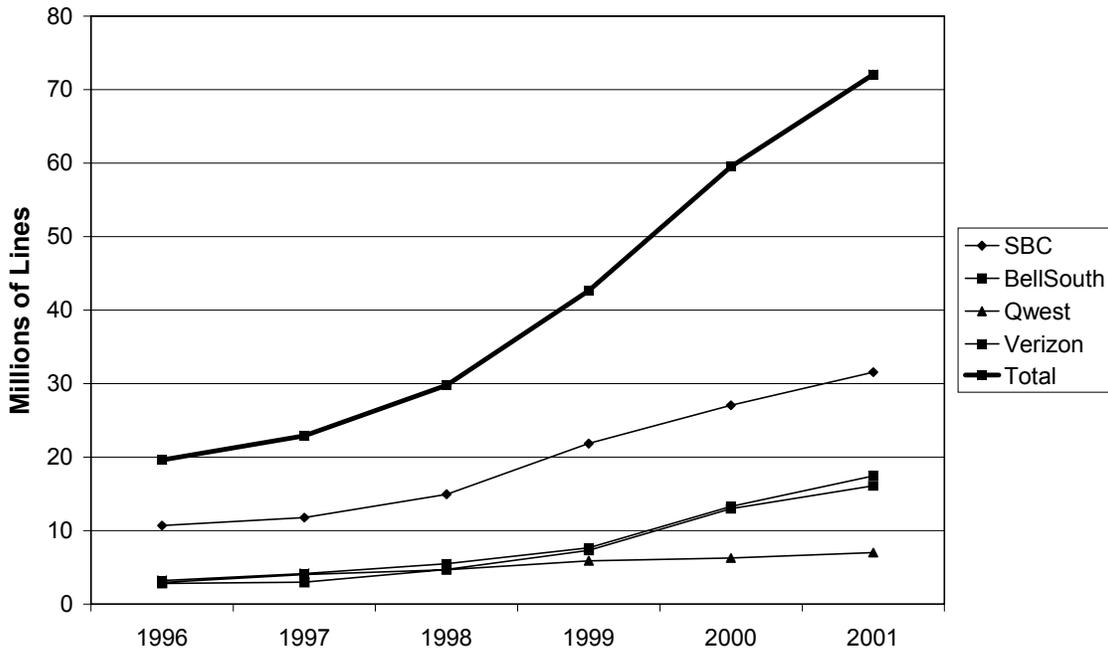
²⁴ Qwest reported ARMIS special access line count data for 1996 through 1999 included channel terminations to the POP. Data for that period reported in this, and subsequent charts dependent on line counts, has been adjusted by the company to remove channel terminations to the POP based on the percentage of channel terminations to the POP in 2000 and 2001.

²⁵ 2002 Special Access Fact Report at 27.

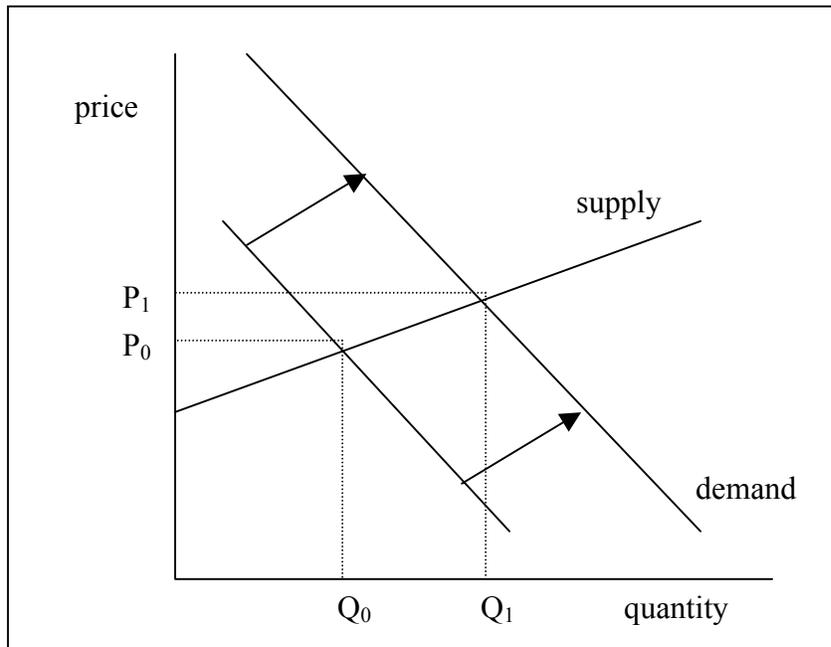
²⁶ 2002 Special Access Fact Report at 12.

²⁷ 2002 Special Access Fact Report at 12-13.

RBOC Special Access Line Growth



In economic theory, growth in demand unrelated to reductions in price is modeled as an outward shift in the market demand curve. In the example below, demand shifts outward and the market-clearing price as well as the volume of sales increases. The market price will increase provided the industry supply curve is not horizontal, and, at least in the short run, there is no reason to believe that the market is willing and able to supply unlimited special access circuits at current prices.



Thus, an increase in prices, revenue and demand volumes is not necessarily evidence that a large firm possesses market power, as AT&T clearly implies. Supply and demand are normally equilibrated in unregulated markets as demand expands by increases in prices and revenue until additional capacity can be brought on line, in reaction to the increased prices.

An additional source of revenue and earnings growth in interstate special access markets has been the recent growth in demand for Digital Subscriber Line (DSL)—an interstate service. DSL technology exploits unused frequencies on existing copper telephone lines to transmit high-speed data traffic — i.e., voice and high-speed data are simultaneously transmitted over the same telephone line — so that its incremental loop cost is small. As a result, increasing demand for DSL service generally increases interstate revenues with little corresponding increase in interstate regulatory costs.

The DSL revenues booked by the RBOCs to their regulated interstate accounts are large and grew rapidly during this period.²⁸ In 2001, BellSouth added more than 600,000

²⁸ SBC provides DSL service through a separate affiliate and does not book DSL revenue to its interstate special access accounts.

subscribers and booked \$264 million of DSL revenue.²⁹ Similarly, in spite of a decline in overall company earnings, third-quarter 2001 results show Qwest DSL revenue grew 80 percent, as the company logged 90 percent growth in the number of subscribers.³⁰ As the first quarter 2001 ended, Verizon had about 720,000 DSL lines — nearly five times more than it operated in the same period the preceding year.³¹ Setting aside the question of whether the *level* of ILEC charges for their DSL services was adequately constrained by competition—primarily of cable broadband, the market share of which was twice that of the telephone companies—these dramatic increases in revenues and earnings attributable to these services can obviously not logically be attributed to any exploitation of their market power over IXCs and CLECs, as AT&T alleges. RBOC DSL revenue for Verizon, Qwest and BellSouth through September 2002 exceeded \$650 million, and, annualized, represents a 112 percent increase over total 2001 revenues of \$410 million.

Once we recognize that demand for special access services is growing rapidly, some other anomalies that AT&T points to in its Petition and the O-W Declaration can be explained. In particular, AT&T complains that special access prices—especially those subject to permissive flexibility—have increased or failed to decrease [Petition at 11-12, O-W Declaration at ¶¶28-30]. At the same time, it expresses dissatisfaction with optional pricing plans (“OPPs”) and term and volume discounts that it is either offered (as an IXC) or required to compete against (as a facilities-based self-supplier). As a matter of fact, using RBOC ARMIS 43-08 data, we find that the *growth* in special access lines fully explains the growth in revenue and that the RBOCs’ average revenue per line between 1996 and 2001 decreased by more than 1 percent per year in nominal terms and by more than 3 percent per year in constant dollars.³²

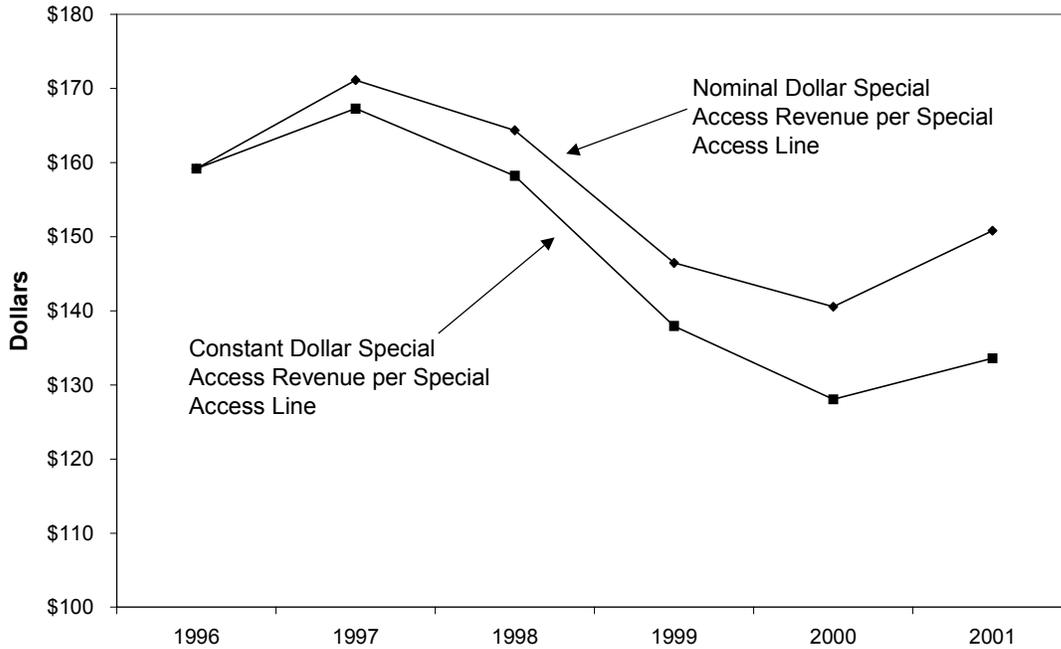
²⁹ See Revenues Rise at BellSouth, Broadband Week Direct, January 22, 2002

³⁰ CNN Money, Qwest Posts 3Q Loss, October 31, 2001.

³¹ Richard Williamson, eWeek, Broadband Still Blooming, May 7, 2001.

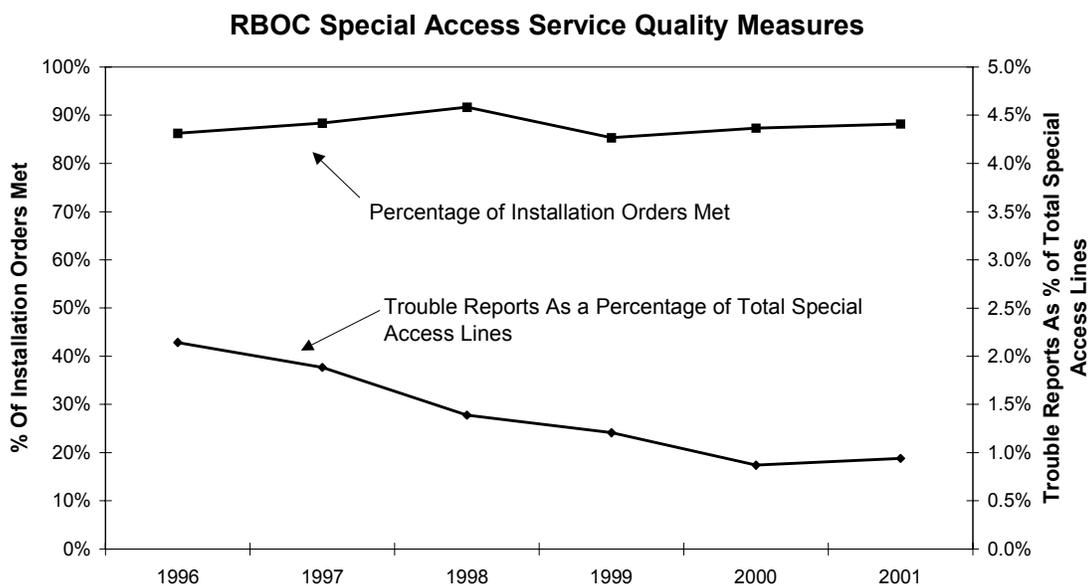
³² Even these decreases are somewhat understated insofar as special access revenue includes DSL revenue but special access lines do not include DSL lines.

RBOC Special Access Revenue per Special Access Line



Thus, the pricing flexibility exercised by some RBOCs during 2001 had no noticeable effect on their special access revenues per line, and AT&T's dire complaints of massive price increases likewise appear to be belied by the data.

Finally, AT&T infers the exercise of RBOC market power from its claim that the quality of the special access services it buys, particularly provisioning, is poor and deteriorating [Petition at 15, O-W Declaration at ¶31]. Again, the ARMIS data, measured per access line or per provisioning order, tell a very different story. On average, trouble reports per access line fell in half during the 1996-2001 period, and the percentage of installation order commitments met has remained consistently high throughout the period. Nothing in the picture remotely suggests the exercise of market power by allowing service quality to deteriorate.



In short, the basic ARMIS data show that on a per-occurrence basis, there has been an improvement, not a deterioration, in the quality of the RBOCs' special access service over this period, let alone any deterioration associated with or attributable to their having been accorded pricing flexibility in 2001 and 2002.

IV. AT&T's Proffered Evidence Has Nothing to do with Pricing Flexibility.

In its Petition and O-W Declaration, AT&T presents quantitative evidence which it claims shows that the pricing flexibility granted by the Commission has been injurious to both competitors and customers. In this section, we show that whatever the merits of these claims, they cannot be attributed to the introduction of pricing flexibility.

AT&T cites RBOC data on the level and growth of special access earnings and revenues for the period 1996-2001 as evidence that special access pricing flexibility has enabled the RBOCs to increase prices profitably.³³ The obvious problem with this

³³ The data is derived in the Declaration of Stephen Friedlander, Exhibits 1 and 2. The Petition graphs both earnings and revenue data for the years 1996 through 2001, and the O-W Declaration repeats the graph of earnings and cites the revenue results. Both the Petition and the O-W Declaration argue that the level and growth of earnings are evidence of market power [Petition at 8, O-W Declaration at 12], and the Petition infers the presence of RBOC market power from the fact that revenue increased despite price increases [Petition at 14].

inference is that special access pricing flexibility began only in 2001 and was implemented transitionally over the 2001-2002 period . According to AT&T,

[a]s of the 2002 tariff filings, approximately 59 percent of the Bells' special access revenues (excluding GTE) are no longer subject to price cap regulation [Petition at 11, no citation of source]

If AT&T is correct, a large fraction of RBOC special access service remains under price cap controls today. Moreover, where pricing flexibility has been granted at all, it has been authorized and implemented quite recently. According to the schedule shown below, the first grant of pricing flexibility was for BellSouth on December 15, 2000, followed by Verizon and SBC (on March 14, 2001). Qwest first received its authorization in April 2002. In interpreting the Table, observe that (i) the date on which pricing flexibility was actually implemented was frequently some two months after the RBOC's petition was approved by the Commission³⁴ and (ii) as the table makes clear, whatever the merits of AT&T's criticisms about the level and growth of RBOC earnings and revenues—merits that we criticized above—they have nothing to do with their authorization to price special access flexibly. RBOC accounting earnings and revenues for interstate special access services grew steadily from 1996 to 2000—*before* pricing flexibility was permitted. Again, according to AT&T, earnings for most RBOCs exceeded 11.25 percent, but that, once again, was before special access pricing flexibility was implemented. Qwest's experience, of course, has no bearing at all on the issue, since it had no such authorization during the period covered by AT&T's data.

³⁴ For example, SBC's first petition for flexibility was approved on March 14, 2001 and implemented in tariffs filed on May 16, 2001. Its second petition was approved on April 11, 2002 and implemented on June 18, 2002.

Number of MSAs Granted Pricing Flexibility							
Authorized			SBC	VERIZON	QWEST	BELLSOUTH	TOTAL
15-Dec-00	Chan Term	Phase 1				11	11
		Phase 2				26	26
	Transport	Phase 1				1	1
		Phase 2				38	38
14-Mar-01	Chan Term	Phase 1	18	13			31
		Phase 2	4	11			15
	Transport	Phase 1	13	6			19
		Phase 2	28	40			68
22-Mar-02	Chan Term	Phase 1		15			15
		Phase 2		8			8
	Transport	Phase 1		6			6
		Phase 2		4			4
11-Apr-02	Chan Term	Phase 1	7				7
		Phase 2	8				8
	Transport	Phase 1					0
		Phase 2	10				10
24-Apr-02	Chan Term	Phase 1			11		11
		Phase 2			20		20
	Transport	Phase 1			2		2
		Phase 2			31		31
22-Nov-02	Chan Term	Phase 1				2	2
		Phase 2				4	4
	Transport	Phase 1				3	3
		Phase 2				4	4

But what about the AT&T argument that high and increasing earnings and revenues imply that RBOCs have had and retain significant market power—that IXCs have no competitive alternatives—so that granting pricing flexibility could have anticonsumer and possibly anticompetitive effects? There are three responses, in addition to the fallacy of using regulatory earnings to measure economic profit, which we will discuss in the next section. First, the levels and trends of the data offered by AT&T were clear to all industry participants in the pricing flexibility docket. Moreover, AT&T and its economists do not claim that the data show a *change* in those patterns after pricing flexibility was permitted, and, indeed, the data show no such change. Hence, AT&T offers no useful *new* information—let alone “years of data”—that the Commission could use to determine if *pricing flexibility* has had undesirable effects.

Second, the trend and level of prices, revenue and earnings for special access in the data offered by AT&T are almost entirely the effect of price cap regulation, including the recent modification approved by the Commission in its CALLS agreement, to which AT&T was a willing signatory. Effects of the reduction in the productivity factor for the special access basket in 2000 are included in the data presented by AT&T, but presumably it and the other signatories to the CALLS agreement received other considerations for that adjustment and ought not to be asking for relief from those effects in this proceeding. Finally, timing aside, the information provided about earnings and revenues has no bearing on the presence or absence of RBOC market power in the special access markets.

V. There are Competitive Alternatives to RBOC Special Access Services.

AT&T says that it continues to rely on the RBOCs' high-capacity networks for interoffice facilities and for customer-premises channel terminations because CLEC services are unavailable or too expensive and self-supply is uneconomic because of its insufficient scale economies and difficulties in obtaining rights-of-way [Petition at 26-32].

Broadly speaking, these claims suffer from one timing problem and two errors of economic logic. As to the former, AT&T makes no attempt whatever to relate this asserted experience to the introduction of pricing flexibility for special access services. Instead, it merely repeats its general contentions about its difficulties in purchasing and supplying dedicated transport and channel termination services that have been thoroughly discussed in previous dockets. As for the erroneous economics, first, AT&T resolutely continues to ignore its ability to provide its own special access facilities; witness its meaningless claim that the "lion's share of AT&T's access dollars go to the Bells" [O-W Declaration at ¶35]. As we will proceed to demonstrate, the total "access dollars" to which it refers are only its payments to other suppliers, not its total outlays for such services—a difference that produces an enormous difference in results. What matters for CLECs and IXCs is that they have economically realistic alternatives to RBOC special access facilities available to them, not that they necessarily purchase them with "access dollars" from third parties. And, second, AT&T's generic claims about economies of

scale and sunk costs are belied by the technology and by the rapid growth of non-RBOC networks that have competed successfully against the RBOCs in those markets since shortly after divestiture.

A. AT&T ignores its ability to supply its own special access facilities.

AT&T complains of difficulties in *purchasing* special access facilities and services from non-RBOC suppliers. Since AT&T purchased TCG, one of the largest independent suppliers of competitive access services and by so doing took its network in-house, this complaint amounts to a blatant application of the orphan defense—in which a child murders his parents and then begs the Court for mercy on grounds that he is an orphan.

During the years in which the Commission examined alternatives to the RBOCs, the participating parties regularly documented the breadth, depth, reach and growth of networks supplied by Competitive Access Providers (“CAPs”) on a wholesale basis to IXC and CLECs and on a retail basis to large corporate customers. The business plan for a typical large CAP (in this case one that has since been acquired by WorldCom) was simple enough:

The Company sells its services primarily to IXCs, ISPs, wireless carriers and business, government and institutional customers who are high volume users of telecommunications services. ... **Through the deployment of state-of-the-art fiber optic networks and switches, the Company is able to provide the IXCs served by its networks with high quality, reliable services at prices less than those the regulated ILECs currently charge.** The Company can expand its capabilities to offer these services beyond the locations served by its networks by interconnecting its facilities with the facilities of the ILECs, IXCs and other providers of telecommunications services....

...**As an early entrant** in selected second and third tier cities, the Company believes it can attain a leadership position by **securing needed franchises and rights-of-way, installing robust state-of-the-art CLEC networks and facilities and establishing customer relationships with IXCs, ISPs, wireless carriers and business, government and institutional end users that will enable it to take advantage of the attractive potential growth rates for local exchange service revenues in those markets.** The Company is also pursuing opportunities in selected first tier markets (those with populations over two million) utilizing the Company's existing operational capabilities in conjunction

with operating agreements with the Company's major IXC customers **The Company's networks are generally designed to access at least 70% to 80% of the identified business, government and institutional end user revenue base and the IXC facilities...and substantially all of the central offices of the ILECs within their markets.**³⁵

Comparing the highlighted passages above with AT&T's litany of difficulties raises obvious questions. If Brooks Fiber could compete successfully against existing ILEC prices by installing "state-of-the-art fiber optic networks and switches" to serve IXCs, what are we to make of AT&T's sweeping assertion that economies of scale and the risk of sunk costs make special access circuits a "natural monopoly?" [O-W Declaration at ¶43]. If Brooks Fiber, as an "early entrant" into second and third tier city markets, can obtain "needed franchises and rights-of-way," how "enormous" is the RBOC first-mover advantage of which AT&T complains? [O-W Declaration at ¶¶44-45]. If Brooks Fiber can access 70 to 80 percent of its business, government and institutional revenue base and IXC POPs and all of the RBOC central offices, why is AT&T able to reach only 5 percent?

Of course, the claims of one such competitor—a competitor, moreover then acquired by the country's second-largest IXC—just as AT&T itself acquired Teleport—might logically be subject to some discount, particularly in light of the subsequent financial history of its acquirer. The fact is, however, that the CAP industry grew rapidly following this and similar business plans throughout the early 1990s. According to FCC statistics,³⁶ CAP route miles and fiber miles grew at annual rates of 59 and 67 percent respectively from 1990 through 1998. Tables 14 and 15 from the FCC's "Fiber Deployment Update for Year End 1998" show the state of the CAP industry roughly at the time the Commission was considering special access pricing flexibility and consolidation in that CAP industry took place.

While consolidation, reorganization and bankruptcies have affected much of the industry since 1990, and devastated it financially in the last year or two, they have not fundamentally affected the physical facilities. The corporate names attached to the circuits in the attached tables may have changed as the growth in fiber capacity caught up

³⁵ Brooks Fiber 10-K Report, fiscal year ending December 1996, emphasis supplied.

³⁶ FCC, "Fiber Deployment Update for Year End 1998."

with and exceeded the growth in demand, but the capacity itself remains in place, as the basis for a great potential elasticity of competitive supply, which continues to protect customers from unjustified RBOC price increases.

Table 14: Competitive Access Fiber Systems -- 1990 to 1998 *									
Company Name	1990	1991	1992	1993	1994	1995	1996	1997	1998
	Route Miles								
Brooks Fiber	109	141	193	264	264	480	1,059	2,494	2,494
Electric Lightwave		6	104	126	225	466	516	952	1,426
e.spire (ACSI)							697	1,061	1,781
GST Telecom							305	415	849
Hyperion							2,887	4,761	5,666
ICG		105	132	151	424	637	2,073	2,872	4,208
Intermedia (ICI)	159	165	213	335	372	561	605	605	1,016
Kansas City Fib. Net	91	94	97	200	200	200			
MCImetro						2,338	2,948	2,948	NA
McLeod USA	65	75	95	121	116	NA	2,352	NA	6,436
Metromedia									380
MFS (WorldCom)	309	546	1,133	1,530	2,387	3,112	3,523	3,858	4,203
MHLightnet									148
NEXTLINK									2,477
RCN									1,700
Teleport (TCG)	468	647	1,158	2,276	4,135	5,823	7,182	9,474	11,417
Time Warner Telecom	59	86	88	96	348	3,312	4,232	5,911	6,968
Total Reported:	1,259	1,865	3,213	5,099	8,471	16,929	28,379	35,351	51,169
	Thousands of Fiber Miles								
Brooks Fiber	2.6	3.8	4.3	6.2	18.0	24.3	71.3	215.2	232.0
Electric Lightwave		0.5	6.8	11.7	20.5	NA	61.5	108.4	128.3
e.spire (ACSI)							48.8	92.5	157.2
GST Telecom							21.5	38.4	64.3
Hyperion							138.6	220.0	272.0
ICG		4.8	6.5	8.6	19.0	28.8	69.6	108.1	132.3
Intermedia (ICI)	2.9	3.0	5.2	10.2	11.3	20.5	24.1	35.0	40.4
Kansas City Fib. Net	2.5	2.6	2.9	NA	3.7	3.8			
MCImetro	NA	NA	NA	NA	NA	NA	NA	NA	NA
McLeod USA	1.6	1.8	3.7	5.0	3.0	NA	123.9	NA	382.9
Metromedia									160.0
MFS (WorldCom)	17.2	29.8	41.4	67.0	106.9	188.0	229.9	283.7	359.6
MHLightnet									4.7
NEXTLINK									195.5
RCN									86.6
Teleport (TCG)	22.2	28.4	43.7	100.5	171.7	267.1	364.8	491.1	549.7
Time Warner Telecom	0.5	1.2	1.2	1.4	10.4	107.9	151.7	233.5	272.4
Total Reported	50	76	116	211	365	640	1,306	1,826	3,038

Table 15: Competitive Access Fiber Systems -- Other Latest Available Data -- 1998 *					
Company Name	Sheath Miles	Average Fibers per Route	Investment Millions \$	Buildings Served	States Served
Brooks Fiber	2,494	93.0	NA	NA	20
Electric Lightwave	1,426	90.0	NA	2,686	7
e.spire (formerly ACSI)	1,781	88.3	NA	3,231	22
GST Telecom	917	75.7	170.6	689	8
Hyperion	NA	48.0	300.0	6,721	12
ICG	NA	31.4	#N/A	5,397	7
Intermedia (ICI)	1,016	39.7	#N/A	4,342	12
Kansas City Fiber Net	#N/A	NA	NA	276	2
MCImetro	NA	NA	NA	NA	33
McLeod USA (formerly MWR)	NA	59.5	193.9	1,028	2
Metromedia	NA	NA	NA	NA	NA
MFS (WorldCom)	4,376	85.6	NA	20,435	23
MHLightnet	148	32.0	NA	8	1
NEXTLINK	NA	NA	NA	NA	NA
RCN	NA	50.9	NA	NA	7
Teleport (TCG)	NA	48.1	NA	20,005	22
Time Warner Telecom	NA	39.1	NA	NA	10

Towards the end of the 1990s, consolidation in the telecommunications industry sharply reduced the number of these competitors, and between 1996 and 1998, the three largest consolidated CAPs were further acquired by AT&T and WorldCom, as we already observed: AT&T acquired Teleport in January, 1998, and WorldCom bought MFS in August 1996 and Brooks Fiber in October, 1997. As a result, the capacity (and growth prospects) for competitive wholesale local exchange facilities was taken off the open market and brought in-house by the two largest IXC's (and two of the largest CLECs). Consequently, there are indeed fewer *independent* CAPs available to AT&T and WorldCom today when they seek alternatives to RBOC special access circuits; but, of course, the capacity of AT&T and WorldCom to supply these facilities themselves increased by the same amount. One cannot simultaneously acquire the major wholesale providers of special access circuits and then, invoking the orphan defense, complain about a shortage of independent supplies or suppliers on the open market!

The bottom line, as AT&T pursues its strategy of moving access services in-house, is of course that the fraction of its "access dollars" that "goes to the Bells"

becomes increasingly irrelevant as a measure of the competitive alternatives to RBOC special access circuits available to it and the other IXCs and CLECs.

B. Special access markets are competitive in theory as well as in fact.

AT&T [Petition at 29, O-W Declaration at ¶¶39-40] describes the technology of loop and dedicated transport services as characterized by either “enormous” or “substantial” economies of scale and sunk costs.³⁷ From this observation, it concludes that special access services are a natural monopoly and (presumably) that competition is or will be insufficient to justify conferring pricing flexibility on the ILECs. To put it another way, AT&T seems to believe that the extensive competition that exists in practice is not possible in theory. Again, AT&T has made this claim before, and nothing in its Petition or Declarations suggests that experience under pricing flexibility has vindicated its claims. The best economic evidence that special access services are competitive is the long and continuing history of entry and expansion of competitors and the steady decline in RBOC market share that has occurred.

Experience, even taking into account the financial meltdown of telecommunications firms, provides in itself sufficient refutation of AT&T’s claims. It is worth, however, pointing to weaknesses in its supporting argument. First, it complains [O-W Declaration at ¶35] that it and other CLECs “have been able to replicate only a small fraction of the Bells’ [entire] high-capacity network.” It has chosen the wrong denominator in calculating that “small fraction”: special access dedicated transport and channel terminations are point-to-point, not switched services, and a ubiquitous network is not necessary to participate successfully as a competitive supplier.³⁸

Second, the main driver of scale economies for local exchange service is customer *density*—serving dense areas permits use of larger cable, larger switches and shorter loop lengths. That source of scale economies is less important for dedicated transport or other point-to-point circuits, which do not use switches and for which individual customer

³⁷ AT&T used the former characterization [Petition at 29], its economists the latter [O-W Declaration at ¶¶39-40].

³⁸ Of course, with interconnection, switched competition need not be ubiquitous to succeed either as many niche competitors have shown.

locations provide a high volume of usage.³⁹ Moreover, insufficient demand on particular routes or inadequate assurance of demand sufficiently enduring to justify incurring the necessary heavy sunk costs [O-W Declaration at ¶¶49-52] may possibly explain why a small CLEC might find it uneconomic to undertake such investment, but they do not explain why a CAP, a group of CLECs or a wholesale fiber supplier could not. Indeed, the experience of the CAP industry has shown a willingness to invest in fiber in such markets. Wholesale local fiber suppliers such as Metromedia Fiber Networks, American Fiber Systems, Yipes and NEON have put fiber in the ground, and even though the current glut of fiber on the market has led to acquisitions, reorganizations and bankruptcies among these firms, the capacity they have installed remains. The fact that the incremental cost of operating that capacity is extremely low means that it can be brought into service quickly in response to a market price increase.

Third, AT&T claims that marketing expense is greater for entrants than for RBOCs because CLECs must “develop a brand” and incur large promotional expenditures to attract customers. As these costs are sunk, AT&T says, they constitute a barrier to entry, so that new entry cannot be relied upon to constrain the RBOCs’ special access rates [O-W Declaration at ¶45]. While these contentions are relevant to the feasibility of retail competition, they are of drastically reduced significance in the special access market, whose services—special access channel terminations and dedicated transport—are sold mainly to IXCs and large businesses. Marketing and promotional expenditures and brand identity for services provided to a small number of long distance companies are much less important than for retail sales to the public at large. Similarly, retail customers of these services are large businesses which purchase them as part of networks supplied generally by the large IXCs. Marketing and branding costs are more of a problem for the RBOCs (which are essentially the new entrants into this market segment) than for AT&T, by far the largest incumbent provider. Irrespective of who the customer is, the claim that CLECs must incur higher costs than RBOCs to establish a brand may apply to some of them but surely not to AT&T and WorldCom, which already have business relationships with nearly every customer and who have long-established

³⁹ That is, customers whose demand volumes warrant DS-1 or higher service can be served efficiently by direct connections from an IXC point of presence without requiring intermediate aggregation.

brands and name recognition, particularly in the market segments for which special access is purchased.

VI. There are no Anticompetitive Effects in Adjacent Markets.

AT&T claims that excessive special access prices impede competition in both local exchange and long distance markets [Petition Section II, O-W Declaration Section V]. The Company has made this argument regularly in the past but has proffered no evidence from the recent experience with special access pricing flexibility to support or justify its relitigation here.

A. Pricing flexibility fosters efficient competition in retail local exchange markets.

AT&T's quarrel here is with the use and commingling restrictions on the availability of unbundled network elements, not with flexibility in the pricing of special access. Its claim is that because of those restrictions, CLECs cannot afford to avail themselves of the opportunity to lease the circuits they need to interconnect their own switches or transport facilities at the favorable TELRIC-based UNE rates, but must instead pay the much higher special access charges of the ILECs. Ignoring for the moment the rationale of those use and commingling restrictions, the argument is on its face peculiar from an economist's perspective. AT&T and its economists are attempting to assure the Commission that if these restrictions are lifted (or special access prices reduced), IXC and CLECs will be more rather than less inclined to invest in their own facilities rather than use those of the RBOCs.⁴⁰ Considering that special access facilities and services are a factor of production for CLECs and IXCs, AT&T is in effect claiming that its demand curve (and those of other CLECs and IXCs) for RBOC special access facilities and services is, perversely, upward-sloping in relation to price. A more likely explanation of AT&T's preference is that its factor demand curve is indeed downward sloping, and it recognizes the economic axiom that, all else equal, a reduction in a factor price leads to its more intensive use. The result might well be more entry, but it would

⁴⁰ AT&T argues that high special access prices *indirectly* impede CLEC investment in switches (O-W Declaration at ¶49) and transmission facilities (O-W Declaration at ¶51) because RBOC facilities are necessary to link CLEC facilities into a network. But at the same time, high special access prices *directly encourage* CLEC investment in their own transmission facilities. AT&T is effectively saying that RBOC

surely be *less* facilities-based and more based on use of RBOC circuits and services. Thus, it is difficult to understand how the assertedly excessive special access prices charged AT&T by the RBOCs could constitute “a major barrier to entry by potential facilities-based competitors into retail markets for local telephony.” [O-W Declaration at ¶48]

In addition, the use and commingling restrictions serve an important economic function: namely to prevent arbitrage between two sets of regulated prices, set intentionally by application of different ratemaking principles. On the one hand, carrier access charges were established at divestiture and set intentionally above incremental cost in order to continue the flow of contribution from long distance services to local exchange services. On the other hand, TELRIC-based UNE charges were set (in principle) at incremental cost (plus a small margin) in order to encourage entry into local exchange telephony. Obviously, applications of these differing ratemaking principles can give rise to different prices for similar services, and the purpose of the use and commingling restrictions is simply to reduce the amount of arbitrage artificially generated by those differences that would undermine the Commission’s regulated carrier access charges.

Finally, it is worth observing that despite AT&T’s concern for the viability of local exchange competition, retail local competition is extremely healthy. In the teeth of a dramatic downturn in the economy and in the telecommunications sector, CLECs continue to invest and CLEC market shares continue to grow. Although UNE-P is probably the fastest-growing method of entry, in most states, substantial facilities-based entry has taken place.⁴¹ While parties can disagree whether the competitive glass is half-empty or half-full, it is certainly the case that CLECs have been able to overcome the potential entry barriers listed by AT&T and compete successfully against the ILECs in the local exchange market.

special access facilities generally behave as complements to CLEC facility investment rather than as substitutes.

⁴¹ See the UNE FACT REPORT 2002, Prepared for and Submitted by BellSouth, SBC, Qwest and Verizon in CC Docket Nos. 01-338, 96-98 and 98-147.

B. Targeted pricing and Volume/Term contracts are procompetitive.

After airing its claims that RBOC special access prices are too high, AT&T then contends that they are, at least in some circumstances, also too low. The O-W Declaration [¶¶53-63] asserts that Phase I and II pricing flexibility would permit the RBOCs to engage in targeted price reductions to discourage entry along particular routes and so prevent competitors from serving IXC, CLEC and end-user customers. The Petition [at 18-23] complains about downward pricing flexibility, customer foreclosure through multiperiod contracts and “severely anticompetitive” OPPs that would commit AT&T to minimum annual purchases over multiple years to obtain a discount.

It is important to point out at the outset that these allegations of strategic anticompetitive behavior are entirely theoretical. AT&T has presented no evidence to suggest it has in fact occurred, let alone as a result of the ILECs’ recent receipt of limited special access pricing flexibility. Nonetheless, in assessing these complaints, three relevant economic points must be borne in mind.

1. Downward pricing flexibility is in itself procompetitive.

In general, regulators should always look upon proposals to restrict price reductions with a jaundiced eye. Price reductions are painful to competitors, but they are the essence of the competitive process. Restricting the incumbent’s ability to lower prices denies consumers the benefit of those reductions immediately and reduces future consumer welfare by weakening competition and allowing inefficient competitors to remain in the market. As three well-known economic advisors to pre-divestiture AT&T observed,

These dangers remain even when regulatory commissions purport to prevent only discriminatory price competition. When an industry is subject to decreasing costs, the only way a supplier can cover his total costs while at the same time taking fullest possible advantage of scale economies is in fact to engage in price discrimination—specifically, to reduce prices selectively down toward incremental costs in markets where demand is relatively elastic. By prohibiting such suppliers from engaging

in selective price reductions in order to protect smaller rivals from the resultant competition, regulatory cartelization fosters inefficiency.⁴²

The offer of special deals to attract or retain customers, whether justified by differences in cost or actually discriminatory in the technical sense, is an essential way in which price competition takes place in the real world. That they may discommode or injure competitors is an inherent consequence; but one of the most fundamental distinctions in economics generally, and antitrust law specifically, is between the inflicting of harm on competitors, with a resulting net increase in consumer welfare, from weakening or impairment of the competitive process, resulting in an ultimate or net decrease in consumer welfare. The distinction is of course extremely difficult to make in practice, but it is absolutely fundamental. The fact that one of us has consistently over the decades emphasized the danger that such selected, discriminatory reductions can be predatory in intent or effect must not be permitted to obscure his consistent recognition of that crucial distinction, in principle. Any general restrictions on the ability of RBOCs to respond to Requests for Proposals or offer optional discount packages would restrict active competitive behavior and harm consumers by denying them both the direct economic benefit of any such offerings and of responses by competitors that they tend to compel, reducing the vigor of competition in the market. Term and volume discounts expand consumer choice and ultimately expand demand, increasing consumer welfare directly. Reasonable termination penalties are an inherent part of the bargain and make such plans possible by reducing opportunities for cheating; without such penalties, the plans could not be offered and the increase in consumer welfare, both direct and indirect, would be lost. Finally, distinguishing among differently-situated customers with optional discount packages can expand sales and increase consumer welfare, so that removing the option of downward pricing flexibility would be anticompetitive. And in all of the above cases, the fact that only the RBOCs would be precluded from using them would distort the process of competition and sacrifice its benefits to special access customers.

None of the foregoing arguments conflicts in any way, in principle, with the repeated emphasis by one of us on the dangers of predation—in particular, typically

⁴² W.J. Baumol, O. Eckstein and A.E. Kahn, “Competition and Monopoly in Telecommunications Services,” November 23, 1970, AT&T Reprint.

manifested in the offer of deep price reductions highly selectively, to combat a typically much smaller competitor, followed by the quick restoration of previously prevailing prices once the competitive threat has been eliminated. But never have his warnings been unaccompanied by an explicit recognition that it would be injurious to competition and the welfare of consumers generally to prohibit the mere offering of special deals and discounts, and by a reminder that such blanket prohibitions would in practice entail a prohibition of competition itself.

The Commission effectuated its concern that selective price reductions might be used to thwart competition in its Pricing Flexibility Order by requiring the presence of competitors using their facilities before pricing flexibility by incumbents would be permitted. AT&T [Petition at 18-21] claims “[e]xperience now shows” that the Commission was mistaken: the only “experience” it cites, however, is the RBOCs’ offerings of OPPs.⁴³ In fact, CAPs and CLECs have already invested heavily in facilities in major markets; those facilities are not going to go away and can be employed competitively at very low incremental costs. Any anticompetitive strategies aimed at frustrating new entry would be too late to be effective. Moreover, the customers for RBOC special access services are largely CLECs and IXC’s, and the largest of them, AT&T and WorldCom, are also the largest owners of CAPs. While AT&T expresses concern that selective price reductions by the RBOCs might make competition difficult for independent suppliers of special access facilities and services, even selective price reductions would have no anticompetitive effect on the decisions of AT&T and WorldCom to supply their own needs, at low incremental cost. Finally, as AT&T has argued on its own behalf for decades—from the time of Telpak to its more recent Tariff 12 offerings—customers are better off when incumbents, in addition to other suppliers, are able to respond to contract proposals from large business customers.

2. OPPs with term and volume commitments fill an important market need.

Any carrier precluded from offering optional pricing plans with term and volume discounts would be placed at a significant competitive disadvantage in the special access

⁴³ AT&T makes the oxymoronic assertion that the RBOCs use market power to *force* carriers to use their *optional* pricing plans (Petition at 21).

market. Long-term contracts are used to minimize risk exposure and stabilize production requirements and costs over time. In addition, when the buyer or seller incurs heavy sunk costs as part of the transaction, both parties are better off under effective long-term contracts. Common examples of such costs in special access markets include network design of customer-specific facilities and the purchase of transaction-specific equipment and facilities. Under such contracts, the buyer and seller are both assured that (i) their sunk costs will eventually be recovered from the transaction for which the costs were incurred and (ii) up-front sunk costs can be amortized and recovered over the life of the transaction, better aligning costs with revenues. Long-term contracts thus have salutary effects in the form of risk and cost reduction for both suppliers and customers.

AT&T complains [Petition at 22-23, O-W Declaration at ¶¶61-62] that the RBOCs have forced it into signing long-term contracts and OPPs that oblige it to “commit to certain levels of annual purchases to obtain the discounts.” It also complains that those contracts come with “sizable penalties for early termination” and that the RBOCs have “insisted on specific penalties for migrating traffic to competitors.” These complaints are without merit. First, the plans are optional, not just nominally but in reality: AT&T is not in fact obliged to choose them. As always, and as it does on a large scale, it can supply its own special access services, purchase them from other competitive suppliers or continue to buy them from the RBOCs at the ordinary tariffed rate.

Second, AT&T admits [Petition at 22, O-W Declaration at ¶62] that the savings it realizes by taking special access service under long-term contract from the RBOCs “dwarf whatever savings AT&T could achieve by using competitive alternatives”: obviously this can mean only that the OPP offers it additional benefits that outweigh the additional restrictions. Having the choice, irrespective of which choice it actually makes, clearly makes AT&T better off. Third, AT&T wants to have its cake and eat it: it values the savings from RBOC OPPs but complains about the penalties that apply for early termination. Such penalties are a standard practice in the offering of long-term contracts because without them, the discounts could not be offered. Obviously, if a customer could sign a long-term contract, obtain a discounted price on the seller’s expectation that it will be fulfilled and then breach it without penalty when a better offer came along, such

contracts, with the benefits they offer both parties, would be simply infeasible in the first place and end user customers would, ultimately, be the losers.

3. RBOC OPPs cannot “lock up” the largest special access customers.

Term commitments in multi-year contracts do not “lock up” customers in an anticompetitive manner, any more than General Motors locks up a customer when it sells or leases a Buick that the customer will drive for the next five years. Every special access carrier offers its customers multi-year contracts with early termination penalties, and while each customer that signs such a contract is in principle removed from the market for the services for which it has contracted, every carrier has a fair shot at securing the customer in the first place. The total demand for data services is growing at double-digit annual rates, and new customers and demands come into the market continuously. There is no reason why competition for multi-year contracts for large customers must be any less vigorous—any less beneficial for customers—than competition confined to month-to-month service arrangements.

Moreover, while AT&T claims that the RBOCs “have locked up the largest special access customers” [Petition at 23], those customers are, of course, the largest IXCs and CLECs—AT&T and WorldCom. As both of them possess extensive local exchange networks from their absorptions of Teleport, MFS and Brooks Fiber, it is difficult to understand how their having the option of entering into term contracts with an RBOC could lock them up involuntarily or subject them to monopolistic exploitation.

C. Long Distance Markets

As in many other dockets since 1984, AT&T [Petition at 23-24, O-W Declaration at ¶¶64-69] asserts that setting access charges above incremental cost has anticompetitive effects in the long distance market, where RBOCs both supply carrier access services and compete for retail customers. The RBOCs, AT&T alleges, can use their “market power in the provision of special access” to sell that service to IXCs at prices above cost, while incurring only the underlying costs themselves in their own use of special access to offer competing long distance services. Such a strategy, AT&T claims, raises rivals’ (i.e., IXCs’) costs, and, in the limit, subjects them to anticompetitive price squeezes. It cites

two post-1999 examples as purported evidence that this theory has some relevance to the current proceeding, but in fact neither example demonstrates anything about the effect of special access *pricing flexibility* on long distance competition.

The flaws in AT&T's reasoning are well-recognized. First, pricing special access services above cost can not impair competition in the long distance market because the RBOC long distance affiliates buy special access under the same tariffs and OPPs as AT&T.⁴⁴ Therefore, pricing special access above cost can not generate a differential advantage for the RBOC's own long distance service or impose an anticompetitive price squeeze on an IXC.

But, AT&T complains, the cost that the RBOC actually incurs in providing access to itself (or its affiliate) is less than the cost its rivals incur when they buy access from it. How could such access prices not be anticompetitive, it asks?

The answer is simple. True, when AT&T wins the retail customer, it may purchase special access from an RBOC, in which event the cost it incurs is the price the RBOC charges, whereas when the RBOC wins the retail customer, it incurs only the incremental cost of providing the equivalent of special access. In the latter case, however, the RBOC also gives up the contribution (price less incremental cost) from special access that it would have received if AT&T had served that retail customer. Special access charge revenue (when AT&T supplies the retail service) is revenue that the RBOC foregoes when it supplies the retail customer itself. The higher that access revenue, the higher the retail price the RBOC long distance affiliate would have to charge to make long distance service profitable for the RBOC as a whole, as well as to make long distance service profitable on the books of its long distance affiliate. Thus AT&T is simply wrong [O-W Declaration at ¶68] when it claims that the RBOC can charge long distance prices "that do not reflect all of the artificially elevated access prices," and "divert substantial business from the IXCs to itself." The RBOC affiliate's retail price reflects to the penny what IXCs pay for access, as is required by both the law and by economic self-interest.

⁴⁴ In particular, Section 272(e)(3) of the Act requires BOCs to purchase carrier access out of the same tariffs as their competitors and to impute those carrier access charges into their long distance prices, so that all competitors effectively pay the same price for the same carrier access services.

Finally, AT&T is wrong again [O-W Declaration at ¶66] in supposing the RBOC can impose a price squeeze, earning a higher margin on its sale of access services to IXC competitors than its affiliate earns on its retail service. First, such pricing cannot occur unless the RBOC affiliate prices its long-distance service below its incremental cost, since the affiliate buys access out of the same tariff as the IXCs. Such predatory pricing is possible, of course, but is an unlikely strategy because it entails the affiliate sacrificing profits for some period of time with no reasonable hope of being able to drive its IXC competitors out of the market, and then raise toll prices without attracting entry and recoup lost profits, greatly facilitated by the ability of entrants to use facilities already in place, at very low incremental costs. Second, if one ignores the affiliate's balance of costs and revenues and looks only at the RBOC's, the same analysis holds. When the RBOC receives from the IXC a greater margin above cost for a minute of access than it receives from selling a minute of retail toll service, it loses money on every minute of those retail sales. For example, assume toll competitors must buy the RBOC's switched access service for 5 cents per minute and the RBOC's incremental cost of supplying access is 1 cent per minute—yielding it a margin or contribution of 4 cents. Suppose, in addition, that the RBOC affiliate's incremental cost for supplying toll is 2 cents per minute. If the RBOC's affiliate prices toll below 6 cents per minute, it would be more profitable to sell access to AT&T than to sell toll at retail.⁴⁵

Hence, AT&T's conclusion that “[t]his strategy may be profitable to the RBOCs” is certainly incorrect in the short run, and only possible in the long run under circumstances in which predatory pricing in the toll market is likely to be a profitable strategy and that, we have pointed out is highly unlikely in a situation of excess capacity.

AT&T offers two examples of recent (post-1999) anticompetitive effects of access charges in long distance markets. The first is an example that apparently pertains to SBC intrastate switched access charges and toll prices in Texas. The relevance of that example to interstate special access pricing flexibility is somewhat murky, and from the details given, one cannot conclude that SBC's affiliate is pricing its toll service below the sum of its toll incremental cost and the contribution (price less incremental cost) from

⁴⁵ A minute of access generates 4 cents of contribution in this hypothetical example. A minute of toll service sold for 5 cents per minute generates 3 cents of contribution.

switched access. The second example has nothing to do with a price squeeze: it merely observes that BellSouth has offered an optional package that combines Fast Packet Access Service and Frame Relay Service at an attractive price. While AT&T complains that it cannot get discounted Fast Packet Access Service without buying Frame Relay Service, it does not explain why that option is anticompetitive. As long as the package is priced so that BellSouth covers its incremental costs as well as the contribution from any access service an IXC must buy from it, the offering is procompetitive, as well as optional. AT&T's complaint amounts to a demand to buy the second item only in a "buy one, get one free" promotion.

VII. Conclusion.

Competitive activity in the special access market continues and continues to grow. RBOC average revenues per line continue to fall; service quality remains high and increases. AT&T's complaints of high RBOC rates of return are based on fully distributed costs and have no bearing whatever on its claims that the RBOCs retain market power. Similarly, AT&T's claims of high or increasing RBOC price-cost margins, especially calculated on the basis of TELRIC, are not evidence of the presence of market power when fixed costs are an important characteristic of the technology. AT&T's own price-cost margins three years after the Commission granted it pricing flexibility equal or exceed the margins of which AT&T complains here.

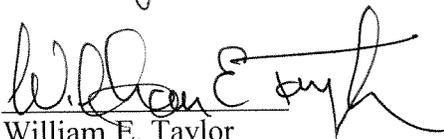
AT&T's submission offers neither factual nor theoretical ground on which to reverse the Commission's long standing policy of adapting regulation to the degree and character of competition in the market.

We declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct.

Executed on Nov, 27, 2002



Alfred E. Kahn



William E. Taylor

CERTIFICATE OF SERVICE

I, Richard Grozier, do hereby certify that I have caused the foregoing **OPPOSITION OF QWEST COMMUNICATIONS INTERNATIONAL INC.** to be 1) filed with the FCC via its Electronic Comment Filing System, 2) served via hand delivery or e-mail on the person/entity on the attached service list marked with an asterisk (*), and 3) served via First Class United States Mail, postage prepaid, on all other persons listed on the attached service list.

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