

**Before the
Federal Communications Commission
Washington, D.C. 20554**

In the Matter of)
)
Review of the Commission’s Rules Regarding)
The Pricing of Unbundled Network Elements) WC Docket No. 03-173
and the Resale of Service by Incumbent Local)
Exchange Carriers)

REPLY COMMENTS OF BT AMERICAS INC.

BT Americas Inc. (“BT”)¹ hereby submits the following in response to comments filed in the above-referenced docket concerning the Commission’s review of its Rules regarding the pricing of unbundled network elements and the resale of service by incumbent local exchange carriers. BT also welcomes the opportunity to comment on the OSP Working Paper No. 40 (FCC 03-224) (“FCC Paper”) entitled “Dynamic Pricing and Investment from Static Proxy Models,” which evaluates the use of static computer cost models and cost studies typically used by regulators in setting forward-looking prices and seeks to address issues related to TELRIC pricing rules.

I. INTRODUCTION

BT applauds the Commission on its substantive review of the TELRIC methodology, and agrees with many of its proposed conclusions. In particular, BT fully supports the Federal Communication Commission’s (“FCC’s”) tentative conclusion that “*TELRIC rules should more closely account for the real world attributes of the routing and topography of an incumbent’s*

¹ BT Americas Inc., a wholly-owned subsidiary of British Telecommunications plc (“BT plc”), is a common carrier authorized by the Commission to provide international switched and private line services (including international simple resale) via its own facilities and resale.

network in the development of forward looking costs.”² However, with regard to the specifics of how TELRIC rules are to be applied, BT would like to offer the following comments. In summary, BT submits that:

1. The use of correction factors, as suggested by the FCC Paper, cannot be supported. Because the calculation of such factors is based on forward-looking assumptions that will be subject to forecasting error, such factors would also increase the regulatory burden and may have adverse consequences on competition.
2. There are good reasons for preferring a top-down approach to LRIC modelling. However, the bottom-up TELRIC methodology suggested by the FCC Paper does ensure an adequate degree of transparency, when combined with publication of the methodologies and the outputs of the TELRIC modelling process.
3. Because TELRIC rules should mirror as closely as possible the real world attributes of networks, it follows that networks should be modelled on a scorched-node basis.
4. External audit, industry consultation, and publication of TELRIC results and methodologies are essential tools for ensuring that the regulatory regime is transparent and fair.

II. CORRECTION FACTORS

The FCC Paper seeks to address the arguments that (1) if investment costs are falling over time, calculation of prices based on TELRIC can prevent incumbents from recovering the costs of their investments; and, conversely, (2) if investment costs are rising over time, TELRIC

² Review of the Commission’s Rules Regarding The Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers, WC Docket No. 03-173, Notice of Proposed Rulemaking, September 10, 2003, Para. 52 (“NPRM”).

pricing will result in an over-recovery of investment costs. The FCC Paper suggests that it is possible in either of these situations to compute a “simple correction factor” that recognizes the trend in investment costs, and ensures that the corrected TELRIC prices recover the incumbent’s investment cost.

BT submits that calculation of such a ‘simple correction factor’ is not, in fact, very simple. In BT’s view, this approach is problematic for the following reasons:

- (i) The methodology suggested is forward-looking. It therefore involves making assumptions about future trends in investment costs that will inevitably be inaccurate to varying degrees. Following these trends and making such forecasts will be an administrative burden. Correcting for any inaccuracies that result – i.e., correcting the historic correction factors – will further increase the regulatory burden.
- (ii) There is also a danger that in a competitive environment an over- or under-correction under this approach could affect the competitiveness of certain product segments, and improperly skew the market.
- (iii) The approach taken towards embedded costs (existing capacity) is not addressed.
- (iv) More thought needs to be given to how any proposed correction factor should be applied. For example, it is unclear whether the FCC is proposing that the correction factor be applied to the TELRIC inputs or outputs, pre-or post Current Cost Accounting (“CCA”) valuation.

In conclusion, it is BT’s view that any benefit accruing from the use of correction factors is outweighed by the increased regulatory burden involved in complying with and policing such

a measure, and by the possible distortion of markets that would result from the inevitable inaccuracies.

III. BOTTOM-UP VS. TOP-DOWN LRIC

In paragraph 52 of the FCC's NPRM, the FCC invites comments on its tentative conclusion that 'TELRIC rules should more closely account for the real world attributes of the routing and topography of an incumbent's network in the development of forward looking costs.' BT agrees with the tentative conclusion, and offers the following specific comments regarding whether to use a 'bottom-up' or 'top-down' model to achieve this.

By contrast to the United States where great use is made of "bottom-up" LRIC models, i.e., independently built cost models, the UK favors the "top-down" approach, in which LRIC data is integrated within the incumbent's financial systems. Across Europe the approach varies according to the preference of the National Regulatory Authority involved, and the state of development, both technical and competitive, of the local market.

Bottom-up LRIC models enable costs to be calculated on a theoretical network structure (although, in practice, the regulated operator's actual network structure would form the basis of the cost model). This in turn makes it easier for a "modified scorched node" ("MSN") approach to be adopted, in which different options in network structure are modelled and one (essentially a redefined node) adopted as the basis for the TELRIC. The MSN approach has been used in some EU countries where a radically different switching structure exists, e.g., the incumbent's existing switching network has too many small switches.

In the UK, BT plc does not use the MSN methodology. Instead, BT plc uses a top-down LRIC approach based on system-driven LRIC calculations including Cost Volume Relationships ("CVRs") at asset type level using a scorched node approach (and not a MSN approach). Based

on our experience, BT believes there should generally be a preference for an integrated top-down LRIC analysis, as this preference ensures consistency with the rest of the operators' financial systems. While it may be good practice to undertake bottom-up modelling where LRIC is being introduced for the first time, bottom-up LRIC should only be used in those instances where there is no reliable top-down analysis, or where it is necessary to assess the extent of cost reductions or efficiencies under the modified scorched node approach.

BT's LRIC modelling, which assumes that all costs are variable and avoidable in the long run (though, admittedly, there is as yet no commonly agreed position in the UK and Europe on how long 'the long run' should be), is broadly consistent with TELRIC as described in the FCC paper. In BT's view, the use of TELRIC represents a valid approach for the assessment of cost-oriented interconnection tariffs when such a remedy is necessary to deal with issues relating to entities having Significant Market Power (SMP). However, this is only appropriate when it is combined with industry consultation on the structure of the model, publication of model outputs and methodology, and external audit of the model. These considerations are discussed below.

A. Scorched Node vs. Scorched Earth

BT supports the scorched node principle precisely because it does more closely account for the real world attributes of network in developing forward-looking costs. In BT's view the only situation where a scorched earth approach is likely to be appropriate is when costing a new service, on the basis of new network infrastructure/platform.

BT believes that the real modelling choice lies between the scorched node and modified scorched node (MSN) assumptions. The starting point for LRIC modelling should be the existing network structure (i.e., scorched node). However, there must be an assessment of whether the existing network infrastructure is efficient, and compatible with forward-looking

assumptions. This is especially important when LRIC analysis is being undertaken for the first time, when it may be appropriate for the incumbent to analyse the potential benefits from adopting a modified scorched node assumption. Implementing a modified scorched node assumption is likely to prove easier in a bottom-up than in a top-down model.

B. Long Run vs. Short Run

Paragraph 55 of the NPRM poses the question: ‘does our tentative conclusion compel us to shift from a long-run average cost methodology to a short-run average cost methodology?’ In BT’s opinion, it does not. Almost all incumbent networks comprise a mixture of legacy and new equipment. Long-run average cost methodologies more closely account for this important, real-world attribute of networks than short-run methodologies would. A shift to short-run methodologies would also have the undesirable effect of increasing the tendency to regard past investment as sunk, which could in turn create difficulties in cost-recovery and deter investment in the provision of network services, whether based on legacy technology or new technology.

C. Asset Lives

The paper states that there is a lack of guidance on asset lives for use in the regulatory pricing models. The FCC seems to have rejected the use of asset lives used in financial Historic Cost Accounting (“HCA”).

Unlike the FCC approach, BT adopts the same lives in the regulatory models (including CCA valuations) as those used in HCA accounts. This is quite a complex area and in setting lives for use in CCA one needs to establish how the HCA lives have been developed and whether they accurately represent the anticipated economic life of the assets.

D. Transparency

Bottom-up TELRIC affords considerable flexibility to an incumbent to choose between various cost treatments while constructing a TELRIC model. Therefore, in order to ensure harmonization and consistency in the application of TELRIC modelling between the different telecommunications incumbents, and to meet non-discrimination and transparency obligations under the regulatory regime, the methodologies used to prepare the TELRIC information and the results of the TELRIC process should be made publicly available. Publication should provide confidence that an SMP operator's charges are properly cost-oriented.

The FCC paper makes reference to transparency and verifiability, but does not comment on the likely need to have an external audit of the TELRIC model, assumptions and financial results. An external audit provides the reader of the LRIC information with comfort that the information is robust and reliable. In addition, consideration should be given to the quality and level of granularity required in both systems and processes to achieve a desired level of audit opinion.

Whichever approach is adopted, there should be industry consultation on the costing methodologies used, and competing operators must have the chance to contribute to the provision of input data. The model itself should be open to inspection by all industry players, and open to revision and amendment on the basis of comments and feedback.

V. CONCLUSION

In conclusion, BT applauds the Commission on its substantive review of the TELRIC methodology, and agrees with many of its proposed conclusions. However, BT does not support the use of correction factors, as suggested by the FCC Paper, because the use of such factors would also increase the regulatory burden and may have adverse consequences on competition.

In addition, BT supports the use of bottom-up TELRIC methodologies as suggested by the FCC Paper so long as an adequate degree of transparency is ensured, through publication of the methodologies and the outputs of the TELRIC modelling process.

BT strongly believes that TELRIC rules should mirror as closely as possible the real world attributes of networks. Accordingly, following this principle, networks should be modelled on a scorched-node basis. Finally, external audit, industry consultation, and publication of TELRIC results and methodologies are necessary and essential tools for ensuring that the resulting regulatory regime is transparent and fair.

Please contact the undersigned should you have any questions or wish to discuss the above.

Respectfully submitted,

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