

**Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554**

In the Matter of)	
)	
Special Access Rates for Price Cap Local Exchange Carriers)	WC Docket No. 05-25
)	
AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services)	RM-10593
_____)	

COMMENTS OF PAETEC COMMUNICATIONS, INC.

J.T. Ambrosi
Vice President, Carrier and Government Relations
PAETEC Communications, Inc.
One PAETEC Plaza
600 Willowbrook Office Park
Fairport, NY 14450
Tel: (585) 340-2500
Fax: (585) 770-2498

Date: June 13, 2005

TABLE OF CONTENTS

TABLE OF CONTENTS.....	i
SUMMARY	ii
I. INTRODUCTION	2
II. DISCUSSION.....	4
A. Special Access Services Continue to be Monopolized by ILECs	4
B. The FCC’s Pricing Flexibility Triggers do not Successfully Predict Competition in Special Access Services, and Price Caps Should be Re-imposed	6
C. Market Power, in Combination with Pricing Flexibility, Enables ILECs to Eliminate Competitive Carriers, and No Real Alternatives to ILEC Special Access Services Exist..	8
III. NEW REGULATORY FRAMEWORK.....	10
A. Retargeting Special Access Rates.....	11
B. Pricing Flexibility	13
1. Unrestricted Downward Price Flexibility.....	13
2. “Low-End” Rate Adjustment Mechanism.....	15
3. Upward Pricing Flexibility Triggers.....	15
C. Annual Price Cap Adjustments.....	17
1. Productivity Factor (X-Factor)	17
2. Line Growth Factor (G-Factor).....	18
3. Earnings Sharing Component	18
D. Application of New Regulatory Framework.....	19
1. Pricing Flexibility	19
2. “Fresh Look” Rights	20
E. Interim Relief.....	22
IV. CONCLUSION.....	24

SUMMARY

PAETEC Communications, Inc., (“PAETEC”) is a provider of competitive local, long distance, data, and Internet services based in Fairport, New York. Primarily serving medium to large business customers, PAETEC provides service to its customers through its own switches and lines leased from other carriers in 28 of the nation’s major metropolitan areas. Specifically, PAETEC leases special access service from ILECs to connect subscriber premises with the nearest PAETEC point-of-presence (“POP”). PAETEC does not rely on unbundled network elements, and it is dependent on ILEC special access services for 95 percent of its last-mile connections to end-users.

The FCC has implemented certain triggers to permit ILECs subject to price cap regulation to implement pricing flexibility for special access services. Although the pricing flexibility triggers were designed to predict the advent of competition for special access service in certain geographic markets, they have not accomplished the Commission’s stated goal of deterring anticompetitive behavior by price cap LECs. ILECs continue to dominate the special access service market, and charge monopoly rents for special access service. As a result, ILECs’ average rates of return for special access have increased dramatically, and they are currently unconstrained either by competition or rate regulation.

In order to remedy this situation, PAETEC urges the Commission to adopt a new regulatory framework to ensure that ILECs are granted pricing flexibility only where and to the extent that competition has truly developed for special access services. Specifically, PAETEC urges the Commission to (1) retarget special access rates in all markets to allow ILECs to receive no more than an 11.25 percent rate of return; (2) permit downward pricing flexibility, with a low-end adjustment benchmark of 10.25 percent to ensure that ILECs do not receive unreasonably

low rates of return for special access services, or, in the alternative, permit upward pricing flexibility only where unaffiliated competitors are providing special access over their own facilities to at least 25 percent of the enterprise customers in a given market; (3) implement annual price cap adjustments to account for changes in market dynamics; (4) reevaluate pricing flexibility already granted to ILECs using the new regulatory framework; (5) permit carriers that have entered into long-term contracts for special access services under the FCC's previous pricing flexibility rules a "fresh look" at those agreements; and (6) adopt interim measures to foster a more competitive landscape.

**Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554**

In the Matter of)	
)	
Special Access Rates for Price Cap Local Exchange Carriers)	WC Docket No. 05-25
)	
AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services)	RM-10593
)	

COMMENTS OF PAETEC COMMUNICATIONS, INC.

PAETEC Communications, Inc. (“PAETEC”) hereby submits its comments in response to the Federal Communications Commission’s (“FCC” or Commission”) Order and Notice of Proposed Rulemaking issued in the above-captioned proceeding.¹ Price cap local exchange carriers (“LECs”) currently enjoy a de facto monopoly in the provision of special access services, despite the Commission’s earlier predictions that competition would develop, and its decision that incumbent LECs (“ILECs”) should be granted pricing flexibility by way of triggers designed to predict the existence of competition. As a result, price cap LECs now earn rates of return on special access services that far exceed amounts that can be considered reasonable.

In order to rein in ever-increasing special access rates charged by ILECs, which only serve to increase their bottom lines while suppressing competition, PAETEC urges the Commission to (1) adopt a new price cap regulatory regime to control monopoly rents charged by ILECs for vital last-mile connectivity; (2) adopt an annual adjustment mechanism including a productivity factor, line growth factor, and earnings sharing component; (3) eliminate the current pricing flexibility triggers and adopt regulations that will permit price cap LECs pricing

¹ In the Matter of Special Access Rates for Price Cap Local Exchange Carriers, Order and Notice of Proposed Rulemaking, WC Docket No. 05-25; RM-10593, 20 FCC Rcd 1994 (rel. Jan 31, 2005) (“NPRM”).

flexibility only to respond to true competition; (4) remove the pricing flexibility already granted to ILECs; (5) permit carriers, like PAETEC, that have entered into long-term contracts a “fresh look” at those agreements to prevent ILECs from continuing to earn inflated profits under the Commission’s pricing flexibility rules, and to avert subsequent damage to those carriers as they would be at a competitive disadvantage compared with carriers that are not locked into extended contracts; and (6) adopt appropriate interim measures to foster a more competitive landscape.

I. INTRODUCTION

PAETEC is a provider of competitive local, long distance, data, and Internet service based in Fairport, New York. PAETEC’s geographic service areas are focused primarily in the northeastern United States, Florida, Chicago, and southern California. PAETEC also provides long distance service throughout the 48 contiguous states. The company concentrates on providing high-quality telecommunications, information and data applications, and related services to customers with demands that require T-1 capacity levels or greater. PAETEC’s customers are mainly medium-size and larger business customers, which include subscribers in vertical markets such as hotels, hospitals, and universities, as well as government and private firms.

Unlike most typical competitive local exchange carriers (“CLECs”), which provide telecommunications service through unbundled network elements (“UNEs”), local resale, or through combination of UNEs and their own facilities, PAETEC has limited its reliance on UNEs. Rather, PAETEC relies almost exclusively on special access for all of its “last mile” connectivity.² In order to reach its subscribers, PAETEC purchases T-1 special access service from ILECs to connect the customer premises with the nearest PAETEC POP.

² As a competitive IXC as well as a CLEC, PAETEC also relies heavily on special access to provide dedicated connections to customers who take long distance, but not necessarily local, service from PAETEC.

PAETEC has a relatively conservative network planning strategy whereby the company generally neither establishes a POP nor does it order circuits to that POP until there is a critical mass of ready-customers to be served by such circuits. That way, operational dollars are not needlessly expended by constructing facilities to an ILEC end office or tandem while waiting for customers to sign up for service. PAETEC's self-owned switches, in combination with leased transport and special access facilities, results in a core network deployment strategy that requires no UNE loops, collocation, UNE transport, enhanced extended loops (or EELs), or dark fiber.³

PAETEC's measured-growth strategy has worked extremely well. Unlike many other competitive telecom startups, PAETEC has never gone through a bankruptcy or financial reorganization, but has managed to grow successfully while honoring its commitments to all of its creditors and investors. As successful as PAETEC has been in the competitive telecommunications marketplace, however, its network and the continued growth of its business is dependent on the availability of reasonably priced special access facilities, which PAETEC leases almost exclusively from ILECs because there are very few alternatives to ILEC-provided services. Given the ILECs' continued dominance in the special access market, PAETEC urges the Commission to implement appropriate rules to ensure that the rates charged by ILECs for special access are reasonable, and to preclude ILECs from engaging in anticompetitive behavior that inhibits competition.

³ Recently, PAETEC has used UNE-P on a very limited basis, primarily to serve smaller branch locations of some of its customers. However, UNE-P is a very minor component of PAETEC's overall service offerings.

II. DISCUSSION

A. Special Access Services Continue to be Monopolized by ILECs

The purpose of the Commission's pricing flexibility rules was to provide regulatory relief for special access services coincident with the development of competition for those services.⁴ The FCC anticipated that competitive forces would work to reduce special access rates, and the Commission determined that pricing flexibility was necessary to ensure that its regulations did not unduly interfere with the operation of the market for interstate access services.⁵ The pricing flexibility rules were designed to grant progressively greater flexibility to ILECs subject to price cap regulation, while ensuring that: (1) price cap LECs do not use pricing flexibility to deter efficient entry or engage in exclusionary pricing behavior; and (2) price cap LECs do not increase rates to unreasonable levels for customers that lack competitive alternatives.⁶

Unfortunately, the objectives of the FCC's Pricing Flexibility Order have not been realized. Rather than causing interstate access charges to move towards forward-looking cost-based levels, rates for special access have either stagnated or increased, resulting in huge rates of return for price cap LECs. For example, the Ad Hoc Telecommunications Users Committee ("Ad Hoc Committee") has determined that the average rate of return has been climbing steadily since 1996.⁷ Today, RBOC average rates of return for special access range from approximately 30 percent to 80 percent, far exceeding the FCC's previously authorized 11.25 percent rate of

⁴ NPRM at ¶ 18.

⁵ Access Charge Reform, Fifth Report and Order, 14 FCC Rcd 14221 (1999), aff'd sub nom., WorldCom v. FCC, 238 F.3d 449 (D.C. Cir. 2001) ("Pricing Flexibility Order").

⁶ Id. at ¶ 3.

⁷ Ad Hoc Telecommunications Users Committee, Ex Parte Submission, "Competition in Access Markets: Reality or Illusion" (Aug. 26, 2004) ("Ad Hoc Committee White Paper").

return.⁸ Year-end data for 2003 showed RBOCs earning returns averaging 43.7 percent, totaling over \$5 billion per year in excess monopoly rents above the 11.25 percent rate of return level.⁹ New data compiled by the Ad Hoc Committee, current through year-end 2004, shows that RBOC rates of return on special access services have climbed even further to an astounding average of 53.7 percent, reflecting a 15 percent increase in special access overcharges from 2003 to \$6.4 billion per year, or \$17.5 million per day.¹⁰

While there has been some criticism of the ARMIS data used to calculate ILEC special rates of return, there can be no controversy regarding the actual rates charged for special access services. Those rates have generally remained steady or increased, contrary to the trend for rates charged for telecommunications services over the past several years, which have generally declined. In addition, the integrity of long-term trends in ARMIS rate of return data is unaffected by minor cost misallocations at the margins.

Furthermore, no real competition has emerged in markets where pricing flexibility has been granted, and competitive providers, like PAETEC, continue to be subject to monopoly rents for special access services. The Ad Hoc Committee reports “that incumbent local exchange carriers remain the sole source of special access connectivity at roughly 98 percent of all business premises nationwide,” and that the FCC has found that competitive alternatives are far from universally available.¹¹ The Ad Hoc Committee’s data is supported by PAETEC’s experience with regard to the availability of special access services in major metropolitan areas.

⁸ In the Matter of AT&T Corp and SBC Communications Inc., Reply Declaration of the Ad Hoc Telecommunications Users Committee, WC Docket No. 05-65 (filed May 10, 2005) (“Ad Hoc Committee Update”).

⁹ Id. at 4.

¹⁰ Id. at 4-5.

¹¹ Ad Hoc Committee White Paper at 12.

As discussed above, PAETEC provides service to medium and large businesses using special access lines, rather than UNEs. PAETEC's customers are generally located in larger metropolitan areas that have a higher concentration of access lines. The markets that PAETEC serves are also those that other competitive carriers seek to serve due to the large number of corporate customers that require high bandwidth telecommunications services.

It is axiomatic that competitive special access providers would focus their efforts on providing alternatives to ILEC special access lines in high-density markets due to the proximity to a lucrative revenue-generating business-customer base. However, rather than being able to obtain alternative means of special access to reach its customers, PAETEC is dependent on ILECs for 95 percent of its special access service lines in these markets. In other words, there are very few alternatives to ILEC special access services to which CLECs can turn as the market for special access end user terminations continues to be monopolized by price cap LECs. The grant of pricing flexibility to ILECs makes it difficult, if not impossible, for competitive special access providers to compete effectively against ILECs in light of their ability to exploit their unconstrained monopoly power. These observations are not anecdotal. They are the observations of a growing competitor in the business telecommunications and information services marketplace that has set the bar for using this type of wireline access to reach its end-users.

B. The FCC's Pricing Flexibility Triggers do not Successfully Predict Competition in Special Access Services, and Price Caps Should be Re-imposed

Given the paucity of alternative special access service providers, it is clear that the FCC's predictive triggers have not worked as originally envisioned, and deregulation through pricing flexibility is premature. The triggers ILECs are required to meet to obtain Phase I and Phase II pricing flexibility have proven to be insufficient in predicting whether special access services are

truly competitive, as they do not examine information necessary to determine whether special access services are available from alternative providers.

To obtain Phase I relief, and specifically, pricing flexibility for special access services for end user channel terminations, a price cap LEC must demonstrate that unaffiliated competitors have collocated in at least 50 percent of the LEC's wire centers within an MSA, or that competitors have collocated in wire centers accounting for 65 percent of the LEC's revenues within an MSA.¹² The problem with this approach is that the Phase I trigger only measures collocation figures – it does not provide any information regarding whether competitors collocating in LEC wire centers are providing special access services to other carriers using their own facilities. Similarly, the Phase II pricing flexibility trigger for special access end user channel termination services only requires ILECs to demonstrate that unaffiliated competitors have collocated in at least 65 percent of the LEC's wire centers within an MSA, or have collocated in wire centers accounting for 85 percent of the LEC's revenues within an MSA.¹³ Again, no examination of whether collocated competitors are actually providing special access services is required under the Phase II trigger.

The real-world result of the Commission's pricing flexibility triggers is that few alternative special access providers have materialized because the triggers are ineffective in identifying markets in which competition has adequately developed to foster rate reductions to forward-looking cost-based levels. The Commission has recognized that intervention would be required if it determined that competition was not developing sufficiently for the FCC's market-based approach to work.¹⁴ Given that the development of competition in special access services

¹² Pricing Flexibility Order at ¶ 103, 148-149; 47 C.F.R. § 69.711(b).

¹³ Id. at ¶ 25; 47 C.F.R. § 69.711(c).

¹⁴ In the Matter of Access Charge Reform, First Report and Order, 12 FCC Rcd 15982, 16003 (1997).

has not come to pass, the Commission should adopt new and interim rules to re-impose price caps at pre-Phase II levels in all markets, regardless of whether ILECs have been granted Phase II pricing flexibility in those markets.

The failure to re-impose price cap regulations in markets where ILECs have been granted Phase II pricing flexibility would render any new or interim rules nugatory as the competitive analyses performed in those markets were premised on the erroneous assumption that the pricing flexibility triggers would identify markets that would be able to sustain competition for special access service. ILECs should be not permitted to continue to harm CLECs and the general public by charging excessive monopoly rents for services that are not controlled either through effective competition or regulation. Indeed, the public interest is not furthered by the ILEC provision of special access services at inflated rates as those costs are ultimately passed on to consumers, who end up paying higher rates for telecommunications services.

C. Market Power, in Combination with Pricing Flexibility, Enables ILECs to Eliminate Competitive Carriers, and No Real Alternatives to ILEC Special Access Services Exist

As discussed by PAETEC and other commenters in this proceeding, including the Ad Hoc Committee, ILECs continue to dominate the market for special access services and control bottleneck last-mile facilities. The ability of ILECs to receive Phase II pricing flexibility without a true assessment of the availability of alternatives to ILEC special access services allows ILECs to freely engage in exclusionary conduct to preclude other carriers from entering into the special access market. Such conditions lend themselves to ILEC predatory pricing and price squeeze techniques to exclude competitors from the market. ILECs can exert such tactics as short term price reductions through contract tariffs that forgo current profits in order to prevent the entry of rival carriers, or to drive competitors out of the special access market.

While there is competition in the market for switched voice, dedicated voice, and data services, carriers providing those services, like PAETEC, continue to rely on ILEC special access and other last-mile connectivity, i.e., unbundled network elements, to reach end users. In order to compete against other carriers, PAETEC must employ network planning strategies to reduce its costs so that it can offer better rates to its subscribers. Part of that strategy involves obtaining favorable special access pricing from ILECs through the use of term commitments to purchase one or more circuits as well as contracts on an individual case basis. These are tactics commonly employed by PAETEC and other special access users to reduce their network costs.

A cursory glance at ILEC federal access tariff filings demonstrates that the tariffed long-term special access service agreements entered into by competitive carriers with ILECs require those carriers to commit to five to seven year terms on circuits or to meet certain revenue commitments. Those same tariffs impose large fees for early contract termination. Given that PAETEC generally has no alternatives to ILEC special access services, these generally available tariff terms as well as individually tailored contract tariff provisions enable competitive carriers to provide telecommunications services to its customers using the most cost-effective means available. The economics of these arrangements are compelling in the short-term but are designed such that if competitive alternatives were to later develop, PAETEC and other similarly situated carriers would not be able to take advantage of those alternatives for several years. In the intervening time period, ILECs would have ample opportunity to engage in exclusionary and predatory pricing tactics that would likely destroy any nascent competitive special access providers.

As further discussed below, in order to remedy this situation, and avoid rendering impotent any subsequent regulatory regime adopted by the Commission for special access

services, PAETEC urges the Commission to permit a “fresh look” at any long-term commitments or contract tariffs so that competitors can either take advantage of new pricing restrictions, or seek service from alternative providers, if any. The adoption of new pricing flexibility rules without permitting a “fresh look” would prejudice carriers that have entered into long-term circuit commitments or contract tariffs because the cost advantage of those arrangements would no longer apply, and less efficient carriers would be the beneficiaries of the Commission’s new regulations.

III. NEW REGULATORY FRAMEWORK

A new special access services regulatory regime is necessary to protect PAETEC and other CLECs from abuses of monopoly power by ILECs, and PAETEC generally endorses the proposals advanced in the Ad Hoc Committee White Paper, with additional modifications as further discussed herein. Although the FCC’s goal of promoting a competitive marketplace is admirable, deregulated markets in which ILECs have been granted increased pricing flexibility are not competitive and have resulted in rate increases for special access services and dramatically excessive ILEC monopoly profits.¹⁵ FCC deregulation of special access services has been premature, and, if permitted to continue, will drive out the small amount of local market competition that has managed to survive.

PAETEC supports the Ad Hoc Committee’s “self-executing” plan for price cap regulation.¹⁶ First, special access rates should initially be retargeted at 11.25 percent, the last authorized rate of return for special access services. Second, ILECs should be granted unrestricted downward pricing flexibility to reduce special access rates in the face of increased competition. In the alternative, if the FCC chooses to retain upward pricing flexibility for

¹⁵ See Section II.A, *supra*.

¹⁶ Ad Hoc Committee White Paper at vi-vii.

ILECs, new triggers must be devised that accurately measure whether competitive entry into the relevant market has occurred. Third, special access rates should be adjusted annually by a price cap rate adjustment mechanism that includes a productivity factor, a line growth factor, and an excessive earnings sharing component. Fourth, markets in which ILECs have been granted pricing flexibility should be reevaluated to determine whether continued pricing flexibility in those markets is warranted. Fifth, the Commission should permit a “fresh look” at long-term special access contracts to avoid unintended market distortions resulting from the FCC’s revised regulatory framework. Finally, interim relief should be implemented in order to prevent ILECs from holding CLECs and special access customers “hostage to protracted proceedings” while they extract \$17.5 million per day in monopoly rents.

A. Retargeting Special Access Rates

In order to eliminate the dramatically high rates of return currently generated by ILEC special access services, all access rates should be retargeted at the last-authorized 11.25 percent rate of return. In the long run, however, the 11.25 percent rate of return should be re-evaluated to more accurately reflect current interest rates, which are significantly lower than those experienced during the late 1980s when the 11.25 percent rate was set.

In addition, the price cap established by this rate of return should be based on current embedded cost rather than the significantly higher historic embedded costs dating back to late 1980s rate of return regulation. In the long run, however, the FCC should set special access price caps at forward-looking economic cost, and eliminate the regulatory distinction between special access services and unbundled network elements (“UNEs”) by setting access charges, like those for UNEs, at Total Element Long Run Incremental Cost (“TELRIC”) under a unified regulatory regime.

Although PAETEC advocates a price cap based on an 11.25 percent rate of return pegged at current embedded costs, these two concessions are made only for expediency. It is vital to the survival of competition in special access markets that the FCC eliminate as quickly as possible the \$6.4 billion per year monopoly rents extracted above the 11.25 percent rate of return level.¹⁷ Every day of protracted debate and litigation over the authorized rate of return and the cost standard to apply imposes \$17.5 million in monopoly rents on CLECs and their consumers,¹⁸ and such a discussion should be delayed in order to achieve the goals of the Ad Hoc Committee's proposal as soon as possible.

Setting an initial 11.25 percent rate of return as a target for access rates is desirable because the rate is still quite high by any measure in the current market where interest rates remain very low by historic standards. Reducing ILEC profits to this level will therefore not stifle ILEC incentives to innovate and operate more efficiently. In the current special access market, where monopoly rates of return sometimes exceed 80 percent,¹⁹ ILECs that have been granted pricing flexibility have no incentive to operate efficiently, invest in new technology, or innovate because, if profits are deemed inadequate, prices can simply be increased. Under the proposed regulatory regime, where some level of ILEC-specific productivity gains are awarded to the innovating ILEC,²⁰ ILECs will retain appropriate efficiency incentives that attempt to reflect as accurately as possible actual market-based competitive incentives.

Indeed, such incentives are necessary due to the lack of viable alternatives resulting from market consolidation and regulatory decisions that created disincentives for facilities-based

¹⁷ Ad Hoc Committee Update at 5.

¹⁸ Id. at 5.

¹⁹ Id. at 6.

²⁰ See Section III.C.3, infra.

competition. Prior to the implementation of the Commission's price cap regime, competitive access services were provided by such carriers as TCG, MFS, and Brooks Fiber. However, as the Commission is aware, those companies and others were acquired by interexchange carriers such as AT&T and MCI Worldcom, leading to a change in business strategy and focus for those formerly standalone companies. The general withdrawal of competitive access providers from the marketplace through acquisitions, coupled with the FCC's emphasis on uneconomical and unstable UNE-based competition, such as UNE-P and EELs, has resulted in a return to ILEC control over last-mile bottleneck facilities, such as special access. The Commission's pricing flexibility rules are unable to overcome ILEC exploitation and control over such critical services, and the use of market-based competitive incentives are necessary to prod ILECs to innovate in the absence of competition.

In addition, reducing rates of return to the 11.25 percent level will serve to stimulate competition in markets for special access services, which, in turn, will also provide greater incentives to ILECs to operate efficiently. Because the costs CLECs such as PAETEC incur in providing services to their customer base will be reduced, these competitive carriers will have more operating capital to invest in developing the infrastructure necessary for more vigorous competition. Also, ILECs' ability to engage in price discrimination, predatory pricing, or "price squeezes" – anti-competitive tactics which drive CLECs from the market – will be reduced because their profit margins will be reduced to levels more closely in line with market rates.

B. Pricing Flexibility

1. Unrestricted Downward Price Flexibility

Once an initial price cap is set based on the implicit 11.25 percent rate of return, ILECs should be granted complete freedom to reduce special access rates in order to respond to competitive challenges in the market. As discussed above, the current system of phased-in

deregulation under the Pricing Flexibility Order grants ILECs the authority to alter their access rates without regulatory approval if certain competitive “triggers” are met.²¹ In virtually every market where pricing flexibility has been permitted, however, ILECs have either maintained high prices or increased them.²² ILECs ability to charge higher prices without losing business to competitors is clear evidence of their pervasive market power and of the inadequacy of the pricing flexibility triggers’ measure of competitive entry into the relevant markets.

The market for special access services reflects the ILECs’ enormous economies of scale and scope: costs associated with providing special access services have consistently decreased along with increases in productivity and increases in demand for telecommunication services.²³ Generally, price increases should only occur in a competitive market if the industry is facing increasing costs. Because the market for special access services faces declining costs, rate increases would not be possible if the market were truly competitive, and hence any rate increases experienced so far because of pricing flexibility have resulted only in monopoly profits for ILECs. Upward pricing flexibility, therefore, is in practice an unnecessary deregulatory mechanism that does nothing but legitimize anti-competitive conduct by ILECs. Indeed, no valid basis for upward pricing flexibility has ever been adequately demonstrated.

Downward pricing flexibility, on the other hand, provides a self-executing regulatory mechanism that would automatically restrict the ability of ILECs to extract monopoly profits while at the same time permit ILECs the flexibility to reduce prices in response to competition. If competition is present, ILECs will have the freedom to reduce prices as a means of meeting competitive challenges. If competition is not present, price caps will act to limit excessive

²¹ Pricing Flexibility Order at 14261; Section II.B, *supra*.

²² AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services, WC Docket No. 05-25, RM-10593 at 4 (Oct. 15, 2002) (“AT&T Petition”).

²³ NPRM at 11-13.

prices. Allowing ILECs unregulated downward price flexibility would also provide increased regulatory stability for all stakeholders in a relatively unstable, litigation-prone industry. In addition, the regulatory regime would eliminate the FCC's administrative burden under the current pricing flexibility rules of making complicated determinations of competitive entry based on inadequate and arbitrary "triggers."

2. "Low-End" Rate Adjustment Mechanism

If the FCC adopts this proposed self-executing regulatory framework, the new regime should also include a low-end adjustment mechanism that would permit an ILEC to increase special access rates if, due to unforeseeable circumstances, the costs associated with providing special access services actually increase such that the ILEC earns returns substantially below the initial target level. The low-end adjustment benchmark should be set no higher than the 10.25 percent level set in the LEC Price Cap Order (100 basis points below the authorized rate of return).²⁴ If ILECs earn returns below 10.25 percent, they would be permitted to increase their rates for the following year in order to achieve the 10.25 percent return. Again, the proposed benchmark rate of return is made only out of expediency as this framework was previously implemented by the FCC and deemed acceptable.²⁵ The low-end adjustment benchmark can be adjusted downward pending any future decrease of the initial 11.25 percent rate of return target.

3. Upward Pricing Flexibility Triggers

The combination of unrestricted downward price flexibility and a "low-end" rate adjustment mechanism should obviate the need for upward pricing flexibility. If costs in the telecommunications industry continue to decrease (as appears to be the case), ILECs will have

²⁴ In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, 5 FCC Rcd 6786, 6806-07, ¶¶ 164-65 ("LEC Price Cap Order").

²⁵ Id.

no need to increase prices in order to respond to market fluctuations, and they will be free to reduce prices in order to compete with new entrants. If costs increase for any reason such that ILECs are unable to attain the initial target rate of return, the low-end adjustment mechanism will insure that they retain a sufficient return on their investment. There would be no need for any FCC determination of market concentration under this framework.

However, if the FCC determines that upward pricing flexibility does serve some viable regulatory objective, new triggers must be devised for gauging whether competitive entry has occurred and is sustainable. The current pricing flexibility trigger, which measures the degree to which competitors have made irreversible, sunk-cost investment in collocation and transport facilities,²⁶ is an insufficient measure of competition in a given relevant market. PAETEC proposes that the Commission adopt triggers that focus on whether actual competition for special access services exists in the relevant geographic area.

Using the FCC's Phase II pricing flexibility triggers as a starting point, the Commission should only permit upward pricing flexibility where unaffiliated competitors have collocated in at least 65 percent of the LEC's wire centers within an MSA, or have collocated in wire centers accounting for at least 85 percent of the LEC's revenues within an MSA. In addition, a LEC should be required to demonstrate that such competitors, in the aggregate, provide access services using their own facilities to at least 25 percent of the enterprise customers in the MSA. PAETEC submits that the upward pricing flexibility trigger will be effective in determining the existence of competition only if the actual availability of special access from competitors unaffiliated with the ILEC is taken into account.

²⁶ Pricing Flexibility Order at ¶ 141-57.

C. Annual Price Cap Adjustments

After initial special access rates are capped at an implicit 11.25 percent rate of return, rates should be adjusted annually based on a multi-factor Price Cap Index (“PCI”). The PCI should include at least the following core components: (1) an inflation measure based on the GDP Price Index, (2) a productivity factor (“X-factor”) accounting for ILEC productivity gains that outperform economy-wide gains, (3) a line growth factor (“G-factor”) accounting for average cost decreases attributable to demand growth, and (4) an “earnings sharing” component requiring ILECs to share excess monopoly profits with buyers of special access.

1. Productivity Factor (X-Factor)

Because of the large economies of scale and scope in the telecommunications industry, ILECs have realized significant productivity gains in the market for special access services as both demand and sales volume have reached unprecedented heights. Annual adjustments to any new price cap regime should have an X-factor component which reduces the price ILECs are able to charge for access by the amount of the sector’s productivity gains which outperform economy-wide gains. Without this factor, ILECs will be permitted to reap rates of return far exceeding competitive levels because of the enormous productivity gains achieved in the industry.

Two methods may be used to calculate any initial X-factor. The X-factor may be independently determined under the rigorous Total Factor Productivity (“TFP”) approach, relying on independent, third-party studies presenting a detailed analysis of productivity growth and an examination of input price changes. Alternatively, an initial X-factor could be established by determining the implicit factor which would be required to maintain the initial target rate of return. Both methods should lead to similar results if the TFP analyses are correct, but PAETEC advocates use of the implicit X-factor methodology for establishing the initial price cap rates

because it can be implemented more easily and simply than the TFP approach (see “Interim Relief,” below).

2. Line Growth Factor (G-Factor)

The X-factor and G-factor are related price cap tools, but the G-factor differs in that it represents a measure of *demand growth* which varies by ILEC, year, and service, unlike the X-factor which provides a relatively static measure of *productivity growth* applying across all ILECs.²⁷ Demand growth for access services reduces ILEC costs because the market for special access reflects scale economies. In other words, ARMIS data implies that special access line demand growth does not produce a proportional increase in special access costs. A price cap regime that fails to account for demand growth will hence produce unreasonably high, monopoly-level rates. In order to measure demand growth for special access, the FCC should look at increases in per-minute special access sales because this is the most precise measure of increases in special access service use. If a G-factor is adopted, due care should be taken to ensure that demand growth efficiencies are not included in determination of the X-factor.

3. Earnings Sharing Component

Even with the well-intentioned adoption of X-factor and G-factor annual adjustments to the price cap for special access services, a price cap may still set prices too high and permit ILECs to extract monopoly-level profits. In the event such a scenario arises, the annual adjustment mechanism should include an earnings sharing component which adjusts an ILEC’s price cap when its rate of return for the previous year exceeds a specified rate of return level.

In a year when an ILEC’s earnings have been particularly high, the ILEC’s X and G-factors likely understated actual productivity or demand growth, and hence a one-time downward

²⁷ NPRM at ¶ 38.

adjustment in the price cap will be necessary in order to prevent monopolistic abuse of the inaccurate price cap. This correction in the price cap index will require ILECs to “share” their additional, unanticipated productivity gains with special access buyers in the succeeding year. If the ILEC’s special access market becomes competitive, such an adjustment will become unnecessary because, under the proposed self-regulating, downward pricing flexibility regime, competition will drive special access rates down to levels permitting a reasonable rate of return, automatically “sharing” these excess revenues.

Any earnings sharing schedule adopted by the FCC should use a percentage of the ILEC’s revenues over the initial 11.25 percent rate of return benchmark as a proxy for determining the additional productivity or demand growth experienced in the preceding year. Such a percentage should not be less than 50 percent. Allowing ILECs to retain at least some percentage of these unanticipated cost reductions will provide incentives for ILECs to innovate and reduce costs further, and will eliminate ILEC disincentives to innovate because the mechanism will require a level of productivity growth closer to the level which would be required in a truly competitive market in order to achieve the corresponding increase in the ILEC’s profits.

D. Application of New Regulatory Framework

1. Pricing Flexibility

The FCC should reevaluate all ILEC markets where pricing flexibility has been granted to date. If the FCC adopts this proposed regulatory regime eliminating upward pricing flexibility, all ILEC markets which had previously been granted pricing flexibility should be subject to the new price cap regime and only permitted to adjust their rates downward without regulatory interference. If the FCC chooses to maintain pricing flexibility, but with heightened standards for measuring competition, all ILEC markets which had previously been granted

flexibility should be reevaluated under the new criteria, and should be restricted by the new price cap regime in the same manner as other ILEC special access markets, unless they meet the new standards. In other words, new regulations should apply equally, across the board, without respect to previous disparities in regulatory treatment.

2. **“Fresh Look” Rights**

Any new FCC regulatory regime implemented in this proceeding should be accompanied by “fresh look” rights for CLECs and other consumers to terminate or renegotiate their service agreements and contracts with the ILECs providing them with special access services. Courts have held that the FCC may “modify ... provisions of private contracts when necessary to serve the public interest.”²⁸ The FCC has exercised this authority and permitted the remedy of fresh look in certain circumstances in order to “promote consumer choice and eliminate barriers to competition in markets where long-term business arrangements have essentially ‘locked up’ service with a former monopoly telecommunications carrier.”²⁹

Specifically, the FCC has previously granted consumers fresh look in the special access context, permitting special access customers to terminate long-term agreements with ILECs in order to obtain the benefits of more competitive alternatives arising from a new regulatory framework.³⁰ In applying the fresh look doctrine, the FCC has considered (1) whether or not the carrier has sufficient market power to create barriers to competition and (2) whether the contract can be nullified without harm to the public interest.³¹

²⁸ Western Union Tel. Co. v. FCC, 815 F.2d 1495, 1501 (D.C. Cir. 1987).

²⁹ Direct Access to the INTELSAT System Order, Report and Order, 14 FCC Rcd 15703, ¶ 118 (1999) (“INTELSAT”).

³⁰ In the Matter of Expanded Interconnection with Local Telephone Company Facilities, 9 FCC Rcd 5154, ¶ 197-208 (1994).

³¹ INTELSAT at ¶ 119.

In this case, long-term arrangements entered into by CLECs and ILECs clearly have the potential to create barriers to competition. ILEC volume and term discount structures force CLECs to “lock in” to long-term circuit commitments or contract tariffs in order to achieve cheaper rates, and significant penalties are imposed for early termination of these contracts. In PAETEC’s case, approximately 95 percent of its special access arrangements comes from some form of long-term arrangements with ILECs, and, without a fresh look policy, any potential new competitor access providers will be precluded from entering the more favorable post-regulation environment because ILECs will still retain long-term control of the vast majority of the special access market. Indeed, across the country, ILECs retain pervasive market power in virtually every market, providing the sole source of “last mile” connectivity to roughly 98 percent of all business premises nationwide.³² ILECs’ enormous rates of return are also evidence of their monopoly-level market power, and these rates permit ILECs to engage in anticompetitive pricing.³³

In addition, the public interest will be well served by permitting CLECs to renegotiate contractual arrangements with ILECs. The FCC has assumed the admirable goal of promoting a competitive market for the provision of special access services, and a competitive market is better for the public – both for direct customers of special access, and for downstream customers of the businesses using special access (because these businesses will be able to reduce their costs and hence their prices). However, long-term arrangements between CLECs and ILECs will severely limit the ability of any new regulatory regime to promote the development of sustainable competitive alternatives. Also, the FCC’s legal obligation to ensure that rates are

³² Ad Hoc Committee White Paper at iv.

³³ See Section II.C, supra.

“just and reasonable”³⁴ requires the FCC to permit CLECs to have a “fresh look” at special access contracts because these arrangements were entered into in a pre-regulatory environment where no real alternatives to ILEC special access existed, and where CLECs possessed very little bargaining power to achieve competitive contracted rate levels.

E. Interim Relief

If the FCC is unable to conclude this NPRM before the expiration of the CALLS plan in June, 2005, interim relief should be implemented in order to prevent ILECs from holding CLECs and special access customers “hostage to protracted proceedings” while they extract \$17.5 million per day in monopoly rents.³⁵ PAETEC supports AT&T’s petition for interim relief that imposes a price cap set at an 11.25 percent rate of return and a moratorium on further price flexibility,³⁶ and requests that the FCC reconsider its initial denial of this interim relief in light of new, updated rate of return data gleaned from this comment period.

The 11.25 percent rate could be applied either as direct rate of return regulation or through adoption of an implicit X-factor set at a level producing an 11.25 percent return, and should apply equally to all ILEC special access markets, especially those currently afforded pricing flexibility. An 11.25 percent return on investment is more than adequate compensation in the current market environment, and reflects a generous concession by both CLECs and consumers in order to obtain at least some form of relief more quickly. After pegging price caps at this initial benchmark, annual adjustments should be made to more accurately reflect forward-looking cost levels, anticipated interest rates, and productivity and demand growth.

³⁴ 47 U.S.C. § 201(b).

³⁵ Ad Hoc Committee Update at 5.

³⁶ AT&T Petition at 6.

However, in the alternative, PAETEC supports the interim 5.3 percent X-factor suggested by the NPRM and endorsed by various parties to this proceeding.³⁷ The 5.3 percent X-factor will produce far more reasonable rates than freezing the X-factor at the current rate of inflation – the current scenario anticipated by the termination of the CALLS plan. However, adjusting current rates merely by offsetting them by this factor will not eliminate the devastating monopoly profits currently extracted by ILECs because it will not compensate for the persistent underestimation of the X-factor throughout and preceding the tenure of the CALLS plan which has resulted directly in the astronomical ILEC rates of return and substantial loss to the business consumer of high capacity wireline services.

In other words, any interim relief fashioned by the FCC must acknowledge that rates have not been at all adequately adjusted in recent years for unexpectedly high levels of productivity and demand growth. Although imposing an accurate X-factor in future annual price cap adjustments is necessary, it is absolutely vital that the FCC acknowledge this “backlog” of productivity gains experienced by ILECs and devise an interim measure to share these gains with CLECs and consumers. Failure to do so, coupled with protracted debate over this NPRM, could foreclose any FCC hope of achieving truly competitive special access markets as CLECs lose market share due to anticompetitive ILEC conduct enabled by astronomically high rates of return. The FCC has a clear legal obligation to ensure that rates are “just and reasonable,”³⁸ and the most reasonable interim solution is a price cap based upon the far less anticompetitive, yet generous, rate of return of 11.25 percent.

³⁷ See, e.g., Letter from Brian R. Moir, counsel for eTUG and C. Douglas Jarrett, counsel for API, to Marlene H. Dortch, FCC (May 10, 2005); Letter from Richard M. Rindler, counsel for ATX, to Marlete H. Dortch, FCC (May 27, 2005).

³⁸ 47 USC § 201(b).

IV. CONCLUSION

For the foregoing reasons, PAETEC Communications, Inc., respectfully urges the Commission to adopt a new price cap regulatory regime for special access services, eliminating price flexibility insofar as it permits rate increases. The new regime should include an annual adjustment mechanism taking account of the special access market's uniquely high productivity (X-factor) and demand (G-factor) growth levels, featuring both a low-end adjustment mechanism and an earnings sharing component. ILECs which have already been granted pricing flexibility should be required to comply with the new regulatory regime, and CLECs and other special access customers should be granted "fresh look" rights at existing long term special access contracts. PAETEC also respectfully requests interim relief, in the form of initial price caps pegged at a target rate of return of 11.25 percent, or, in the alternative, an X-factor of 5.3 percent.

Respectfully submitted,

/s/

JT Ambrosi
Vice President, Carrier and Government Relations
PAETEC Communications, Inc.
One PAETEC Plaza
600 Willowbrook Office Park
Fairport, NY 14450
Tel: (585) 340-2500
Fax: (585) 770-2498

Date: June 13, 2005

CERTIFICATE OF SERVICE

The undersigned hereby certifies that on this 13th day of June, 2005, a true and correct copy of the foregoing Comments of PAETEC Communications, Inc., was served via electronic mail on the following:

Marlene H. Dortch
Office of the Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington D.C. 20554
(via ECFS filing)

Best Copy and Printing, Inc.
Portals II
445 12th Street, S.W.
Room CY-B402
Washington, DC 20554

Tamara Preiss
Chief, Pricing Policy Division
Federal Communications Commission
445 12th Street, S.W.
Washington, DC 20554

/s/
JT Ambrosi