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

In the Matter of:	)	
	)	
Special Access Rates for Price Cap Local Exchange Carriers	)	WC Docket No. 05-25
	)	

JOINT COMMENTS OF IOWA TELECOMMUNICATIONS SERVICES, INC. AND VALOR TELECOMMUNICATIONS OF TEXAS, L.P.

June 13, 2005

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Iowa Telecommunications Services, Inc. ("Iowa Telecom") and Valor Telecommunications of Texas, L.P. ("Valor") hereby file joint comments in response to the Federal Communications Commission's ("Commission" or "FCC") Notice of Proposed Rulemaking in the above-captioned proceeding. The Commission has requested comments on the regulatory scheme that the FCC should adopt for special access services after the revisions to its rules that it adopted as part of the *CALLS Order*[1] no longer apply. Specifically, the Commission asks a series of questions, concerning almost every major issue originally raised – and often rejected – with respect to the price cap rules over the last fifteen years. As indicated more fully below, the market for special access services has become sufficiently competitive in recent years to justify further deregulation beyond that permitted in the current rules and without the currently required factual demonstrations. These market factors obviate any need to adopt any of the price cap "baggage" that have been part of past price cap rules. Therefore, the Commission should maintain the current rules under the CALLS plan applicable to special

[1] *Access Charge Reform*, Sixth Report and Order, 15 FCC Rcd 12962 (2000) ("*CALLS Order*").

access and adopt additional pricing flexibility for price cap incumbent local exchange carrier ("LEC") special access services.

I. INTRODUCTION

A. The original price cap mechanism: origin and overview

The FCC adopted price cap regulation in 1991 when incumbent LECs still had statutorily conveyed monopolies over local exchange facilities in their territories.[2] Price caps replaced more traditional rate-of-return regulation and was designed to provide incentives that would encourage incumbent LECs to become more efficient, while ensuring that rates remained within a zone of reasonableness.[3] The price cap mechanism itself, including the pricing flexibility that it afforded carriers, was designed to resemble more closely the way prices behave in competitive markets. It was intended only as a transitional mechanism until market forces would replace rate regulation altogether.[4]

The original incumbent LEC price cap formula allowed prices to change in accordance with a formula that adjusted rates up for inflation, down by a productivity factor, and up or down for certain limited categories of exogenous cost changes. Services were benchmarked at then-effective tariffed rates. The initial plan allowed carriers to select at the beginning of a tariff year one of two separate productivity factor choices, 3.3 or 4.3 percent. Carriers that selected the 3.3 percent factor were required to share with customers 50 percent of earnings between 12.25 and 16.25 percent and 100 percent of earnings over 16.25 percent. The sharing thresholds for 4.3

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2 *See Policy and Rules Concerning Rates for Dominant Carriers,* Second Report and Order, 5 FCC Rcd 6786 (1990) ("*LEC Price Cap Order*").

3 *Id.,* at 6786, ¶¶ 2-4.

4 *Price Cap Performance Review for Local Exchange Carriers,* First Report and Order, 10 FCC Rcd 8961, 9055 (1995) ("*1995 Price Cap Review Order*").

percent carriers were 13.25 percent and 17.25 percent, respectively.[5] If earnings during the preceding year were lower than 10.25 percent, carriers were allowed to increase prices to target rates to earn 10.25 percent, a low-end adjustment designed to prevent confiscatory regulation of prices.[6]

The plan created four separate price cap baskets: common line; traffic-sensitive; special access; and interexchange services.[7] Carriers were limited in setting prices so that total revenues within a basket could not exceed the price cap as determined by the formula based on historic demand figures. Services within the common line and traffic-sensitive baskets were more closely regulated with limits on how much services within each service band could be raised or lowered. Moreover, the "g" factor also applied to common line service to address an anomaly in the manner in which incumbent LECs recovered non-traffic sensitive costs.

Within the special access service basket, four service bands were established: (1) voice grade/WATS/metallic/telegraph; (2) audio/video; (3) high capacity/Digital Data Service; and (4) wideband data/wideband analog.[8] Service categories were established to place similar services in the same category: prices within each band could not be raised or lowered more than five

[5] *Id.*, at 8967, ¶¶ 7-8. Contrary to the incentive basis for the price cap system, the sharing mechanism required incumbent LECs to "share" with their interstate access customers revenue that carriers earned in excess of Commission established sharing thresholds.

[6] *Id.*, at 9034, ¶ 164.

[7] *Id.*, at 8968, ¶ 13. The price cap baskets were also changed over time. For instance, in 1994 the FCC established a new trunking basket in which it included interoffice switched transport, wideband special access services, tandem-switch transport, signaling and interconnection charges. A new video dialtone basket was created, but eliminated by 1997. The interexchange basket was eliminated altogether in 1999.

[8] *Id.*, at 8968-69, ¶ 14.

percent without a special showing.[9] DS-1 and DS-3 services could only be changed no more than plus or minus five percent a year out of concerns for strategic pricing of these services at that time.[10] As long as prices were set in accordance with the price cap rules, carrier tariffs were allowed to take effect on fourteen days notice with a presumption of lawfulness, deemed a "no suspension" zone.[11]

As market and competitive factors evolved, price cap regulations were substantially changed over time as the FCC gained more experience with the regulations, and better understood the effect of its regulations on pricing and the marketplace. Each of these changes has incrementally led to a more deregulated regime, building on past changes and increasing the amount of flexibility provided to carriers as market competition has grown and flourished.

The price cap mechanism was made mandatory for Bell Operating Companies ("BOCs") and GTE. Any other incumbent LEC could voluntarily opt into price caps, but once the election was made it was permanent. A small number of carriers voluntarily opted into price caps. The FCC failed, however, to tailor its regulations to take into account the unique needs of mid-sized and smaller carriers,[12] despite the fact that there was substantial evidence that smaller incumbent LECs required modified (and often relaxed) regulation.[13]

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9 *Id.*, at 9058, ¶ 221.

10 *Id.*, at 8969, ¶ 15.

11 *Id.*, at 8968, ¶¶ 11-12.

12 *Price Cap Performance Review for Local Exchange Carriers*, Fourth Report and Order, 12 FCC Rcd 16642 (1997) ("*1997 Price Cap Review Order*").

13 *Reply Comments of ITTA*, CC Docket No. 94-1, at 2 (Apr. 17, 2000).

B. CALLS regime: a change in course

The FCC adopted the *CALLS Order* in 2000, based on a recommendation made by large incumbent LECs and interexchange carriers ("IXCs"). The CALLS plan was designed to be a transition plan that would solve a number of contested issues, until more permanent reforms could be made to intercarrier compensation in general. The *CALLS Order*, adopting the CALLS plan in modified form, incorporated this transitional aspect. In a separate proceeding, the Commission has solicited comment on the need for comprehensive intercarrier compensation reform.[14] Among other things, the *CALLS Order* made significant reductions in switched access charges, rationalized the rate structure and levels for common line charges, and turned the productivity factor into a temporary mathematical mechanism to achieve price reductions to specific rate elements and then set equal to inflation.[15] The CALLS plan was originally intended to last five years, but there was no specific sunset provision adopted in the rules.

The CALLS Order reestablished the special access services basket. Special access services were separated from the trunking basket services in order to prevent incumbent LECs from potentially reducing the price of special access services, the price cap services most subject to competition, while raising the price of trunking services, subject to a lesser extent of competition, as would be permitted for services with the same trunking basket.[16] A new X-factor applied to the special access services basket – 3.0 percent in 2000, 6.5 percent in each of the next three years. It was set equal to inflation beginning July 1, 2004.[17] The Commission relied upon

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[14] *Developing a Unified Intercarrier Compensation Regime*, Further Notice of Proposed Rulemaking, FCC 05-33 (Mar. 3, 2005).

[15] *See CALLS Order*.

[16] *Id.*, at 13033-34, ¶ 172.

[17] *Id.*, at 13025, ¶ 149.

mandatory limited rate reductions under the transformed X-factor coupled with the pre-existing effective rate cap to ensure that rates remained in a zone of reasonableness.

Through the acquisition of former GTE price cap territories, Iowa Telecom and Valor have continued to operate as price cap carriers. As such, they had little practical choice but to adopt the CALLS plan.[18] There were certain provisions that were made part of the CALLS plan that were designed to accommodate mid-sized and small price cap carriers.[19] Even these accommodations, however, were not sufficient to take all smaller price cap carrier circumstances into account.[20]

C. Special access regulation: a legacy of incremental deregulation

The FCC has consistently recognized that competition for special access services has grown faster than that for switched services and has taken deregulatory steps to reflect that market fact. Beginning in 1992, the FCC allowed special access and switched transport services to be deaveraged within geographic regions within a study area to reflect more closely the costs associated with providing those services.[21] Pricing flexibility was further increased in 1999; in

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18 Although the Commission gave all carriers an option to select either the CALLS plan or the opportunity to set all access rates at forward-looking economic costs ("FLEC"), no carrier knew at that time the manner in which the FLEC option would be implemented, and therefore, it was not a viable choice within the truncated period of time given to carriers in order to determine whether or not to elect into the CALLS plan.

19 For example, smaller carriers could set their average switched access rates at $0.95 instead of the $0.55 BOC rate. *CALLS Order*, at 13021-22, ¶ 142.

20 *See* Section IV.B.; *see also Petition for Forbearance of Iowa Telecommunications Services, Inc. d/b/a Iowa Telecom Pursuant to 47 U.S.C. 160(c)*, Order, 17 FCC Rcd 24319 (2002). (Iowa Telecom was permitted to set its average switched access rates above the $0.95 target for smaller carriers based, in part, on a FLEC showing).

21 *See, e.g., Expanded Interconnection with Local Telephone Company Facilities*, Report and Order and Notice of Proposed Rulemaking, 7 FCC Rcd 7369 (1992).

doing so, the Commission recognized that competition in the marketplace had been growing, justifying taking additional deregulatory steps.[22]

In the *Pricing Flexibility Order*, the Commission immediately relieved carriers of most of the constraints on geographic deaveraging for trunking basket services, including special access services. Further deregulation was permitted in two phases: Phase I allowed incumbent LECs to price special access services on one day's notice pursuant to volume and term discounts and contract tariffs; Phase II freed incumbent LECs from Part 61 and 69 regulations altogether. An incumbent LEC could obtain Phase I relief if it proved that unaffiliated competitors collocate in 15 percent of wire centers in a Metropolitan Statistical Area ("MSA") or in wire centers that represent 30 percent of revenues from these services. An incumbent LEC could obtain Phase II relief if it demonstrated that unaffiliated competitors collocate in 50 percent of wire centers in an MSA or in wire centers that represent 65 percent of the revenues from these services. The FCC has granted numerous petitions for pricing flexibility for special access services, but mid-sized and smaller price cap carriers have not received additional flexibility.[23]

All of the deregulatory steps taken with respect to special access services have been a measured response to marketplace realities and the FCC's continued recognition of the dramatic growth of alternative special access providers. There has been a steady increase in the amount of pricing flexibility provided to incumbent LECs, particularly for special access services, based on demonstrated market changes that convinced the FCC that prices would be constrained by market forces, rather than government regulation. Although AT&T has sought for three years to

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[22] *Access Charge Reform*, Fifth Report and Order and Further Notice of Proposed Rulemaking, 14 FCC Rcd 14221 (1999) ("*Pricing Flexibility Order*").

[23] *See, e.g.,* A*meritech Petition for Pricing Flexibility for Special Access and Dedicated Transport Services, et al,* Memorandum Opinion and Order, 19 FCC Rcd 10298 (2004).

turn back this clock based on incomplete evidence and distorted facts, the FCC has so far rightly refused to alter price cap regulation of special access services.[24]

II. THE FCC WAS CORRECT IN REFUSING TO GRANT AT&T'S 2002 PETITION TO REREGULATE SPECIAL ACCESS SERVICES.

In its petition for rulemaking AT&T claimed that the Commission should "revoke pricing flexibility and reinitialize price caps to levels designed to produce normal, rather than monopoly, returns."[25] In addition, AT&T requested that the Commission should, "as an interim measure, (1) reduce all special access rates subject to Phase II pricing flexibility to levels that would produce an 11.25% rate of return, and (2) impose a moratorium on consideration of further pricing flexibility petitions pending completion of this rulemaking."[26] There is no basis in fact or law for undermining the Commission's careful deregulation of special access services over the past fifteen years. Adopting AT&T's position would also be inconsistent with Congress's directive that the Commission deregulate, not reregulate, telecommunications services — particularly services where rates are declining and incumbent LECs face fierce facilities-based competition from intra-modal and inter-modal providers that often bypasses the incumbent LECs' networks entirely.

The Communications Act of 1934, as amended, makes clear that the Commission must "reduce regulation" where justified and, to this end, mandates that the Commission review *all* of its regulations every two years and eliminate any regulations that are no longer necessary, and further requires that the FCC forbear from enforcing regulations that are no longer necessary or

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24 *AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services,* RM-10593 (filed Oct. 15, 2002) ("*AT&T Petition for Rulemaking*").

25 *Id.*, at 6.

26 *Id*.

in the public interest.[27] Even before the 1996 Act,[28] the Commission likewise has emphasized that, for special access services, regulation should be used "only where and to the extent that competition remained absent in the marketplace."[29] Granting AT&T's Petition would clearly be inconsistent with Congress's and the Commission's long-standing goals of reducing regulation where justified and avoiding actions that undermine competition by inappropriately regulating services that are provided in competitive markets. The FCC properly refused to grant AT&T's unsupported petition and should continue to reject the petition's requests in the instant proceeding.

Moreover, AT&T's Petition, as well as the *Notice*, fails to mention any need to alter any special access regulations for mid-sized and smaller price cap carriers, like Iowa Telecom and Valor. Thus, even if the Commission were to take action to reregulate special access services, which it should not for any incumbent LEC, the existing regulations under the CALLS plan should continue to apply to mid-sized or smaller price cap carriers and such carriers should be granted increased opportunities for pricing flexibility in the instant proceeding.

A. Existing price cap regulation more than adequately constrains incumbent LEC behavior.

In the *Notice*, the Commission states that existing special access regulation is designed to "act as a substantial bar on the LEC's ability to engage in anticompetitive behavior."[30] These

27 *See* Preamble to the Telecommunications Act of 1996; *see also* 47 U.S.C. § 161 (requiring the Commission "in every even-numbered year" to "review all regulations" and "determine whether any such regulation is no longer necessary in the public interest"); 47 U.S.C. § 160 (mandating that the Commission "shall forbear" if a three-part test is met).

28 Telecommunications Act of 1996 ("1996 Act"), Pub. L. 104-104, 110 Stat. 56 (1996).

29 *1995 Price Cap Review Order*, at 8989, ¶ 64.

30 *Special Access Rates for Price Cap Local Exchange Carriers*, Order and Notice of Proposed Rulemaking, WC Docket No. 05-25, FCC 05-18, ¶ 48 (rel. Jan. 31, 2005) ("*Notice*").

regulations also ensure that rates remain just and reasonable. All evidence confirms that current special access regulations accomplish these goals.

The special access rates of Iowa Telecom and Valor have declined steadily every year since the FCC adopted the current regulatory scheme, confirming that current regulations constrain special access rates. In particular, the following charts show the respective rate decreases for Iowa Telecom and Valor:

IOWA TELECOM[31]

SERVICE	1999 RATE	JUNE 2004 RATE
DS1 Channel Termination	$300.84	$235.00
DS-1 (10 mile circuit)	$777.73	$607.30
DS-3 (10 mile circuit)	$9,008.00	$8,862.50
Clear Channel Capacity	$800.00	$350.00

[31] Rates provided are month-to-month rates for the Iowa Telecom Systems Service Group tariff entity included in COSA COIT under GTE and COSA ITIT under Iowa Telecom.

VALOR

SERVICE	1999 RATE	JUNE 2004 RATE
DS1 Channel Termination		
TX 1 (former GTTX)	$250.00	$190.00
TX 2 (former COTX)	$260.00	$225.00
NM 1 (former GTNM)	$300.00	$244.07
NM 2 (former CONM)	$267.83	$216.61
OK (former GTOK)	$275.00	$259.35
DS1 (10 mile circuit)		
TX 1 (former GTTX)	$709.50	$589.90
TX 2 (former COTX)	$699.00	$594.10
NM 1 (former GTNM)	$721.26	$615.16
NM 2 (former CONM)	$665.34	$545.96
OK (former GTOK)	$737.70	$728.70
DS3 (10 mile circuit)		
TX 1 (former GTTX)	$4,332.50	$3,780.00
TX 2 (former COTX)	$10,473.78	$3,630.00
NM 1 (former GTNM)	$5,969.40	$3,710.00
NM 2 (former CONM)	$13,523.26	$3,710.00
OK (former GTOK)	$3,716.40	$3,721.50

Similarly, the record evidence is devoid of any allegation of anti-competitive conduct by these carriers. Iowa Telecom and Valor strive to provide excellent service at just and reasonable rates, consistent with the law. Existing regulations are more than sufficient to discipline carriers' rates and conduct and there is no need for any reregulation, particularly with respect to mid-sized and smaller price cap carriers.

B. AT&T's purported evidence for justifying reregulation of special access services does not prove the facts for which it is offered.

AT&T's only "evidence" submitted to date includes: (1) BOC special access revenues allegedly have increased based on BOC Automated Reporting Management Information System ("ARMIS") reports; and (2) BOCs allegedly increased certain rates following pricing flexibility. With this "evidence," AT&T concludes that the allegedly unlawful BOC special access rates render "[m]eaningful facilities-based competition … not possible." None of this purported "evidence" supports its draconian request to increase regulation of a competitive market segment. As detailed below, AT&T's reliance on ARMIS for purposes of showing high special access rates is fundamentally flawed, as the Commission already has made clear. In addition, AT&T improperly isolates certain BOC rates without analyzing the trend in overall special access rates, rates contained in contract tariffs, or whether such rates reflect the valid market factors. Finally, the marketplace evidence of widespread facilities-based competition, including competition in areas served by Iowa Telecom and Valor, wholly refutes AT&T's conclusion that facilities-based competition is "not possible."

First, AT&T did not include any evidence to support its requests that regulation should be modified for mid-sized or smaller price cap carriers. Even with respect to the BOC "evidence" it submitted, the Commission already has made clear that ARMIS data should not be used for establishing new regulations. Indeed, the Commission found almost fifteen years ago that rates of return based on ARMIS data "do not serve a ratemaking purpose."[32] This FCC decision is clearly correct given the arbitrary nature of cost allocations among ARMIS categories, which do not fairly track expenses and revenues for special access services. The arbitrary cost allocations

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[32] *Policy and Rules Concerning Rates for Dominant Carriers*, Order on Reconsideration, 6 FCC Rcd 2637, 2677, ¶ 194 (1991) ("*LEC Reconsideration Order*").

ignore market dynamics and lead to skewed and ultimately arbitrary ARMIS data that tend to overstate the true costs and expenses for special access services, a matter only exacerbated by the current separations freeze. Such understatements in separated expenses lead to overstatements of rates of return. Indeed, the Commission recognized the distorting effect of the separations freeze on rate of return calculations in the *Notice*, observing that "cost allocation rules and factors such as the current separations freeze may undermine the usefulness of examining rates of return derived from ARMIS data."[33]

Second, there is no basis for AT&T's sweeping conclusion that any alleged increases in BOC special access rates following pricing flexibility necessitates regulatory intervention. If AT&T believes that any BOC rate is unjust and unreasonable, the proper vehicle to address this is by filing a complaint and prove that the rates violate sections 201 and 202 of the Act—not forced reregulation of a competitive market with respect to all incumbent LECs. Moreover, even if AT&T's claims were true, which Iowa Telecom and Valor submit AT&T has not established, AT&T's argument overlooks the FCC's acknowledgment in the *Pricing Flexibility Order* that "some access rate increases may be warranted, because our rules may have required incumbent LECs to price access services below cost in certain areas."[34] Further, AT&T ignores the significant discounts available through volume and term discounts. AT&T's argument thus misses the mark and fails to support its radical request. In short, there is no basis for adopting AT&T's draconian request for category-wide rate changes based on its limited anecdotal "evidence."

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[33] *Notice*, ¶ 169.

[34] *See Pricing Flexibility Order*, at 14301-02, ¶ 155.

Third, there is substantial competition across the country for special access services. Such competition exists in all areas, including territories served by mid-sized and smaller price cap carriers, as highlighted below. In fact, imposing increased regulation as AT&T requests would undermine facilities-based competition by introducing new regulatory uncertainty and substituting government decision-making for consumer-driven market forces. Such a result is inconsistent with the deregulatory goals of the Act as well as FCC precedent regarding special access regulation.[35] The Commission should not introduce new regulations that will "unduly interfere with the development and operation" of the special access market.[36] Instead, the Commission should continue to implement market-based approaches to spur additional investment and even more robust competition.

C. AT&T's Petition excludes mid-sized and smaller price cap carriers

Notably, AT&T's Petition focuses solely on special access services provided by "large ILECs, and particularly the Bell Operating Companies…" that have received pricing flexibility and does *not* request any regulatory changes for mid-sized and smaller price cap carriers, such as Iowa Telecom and Valor. Yet, the Commission, in the *Notice*, inexplicably proposed special access regulation changes for all incumbent LECs—not just the largest incumbent LECs. There is no justification to support modifying the existing regulatory treatment of mid-sized and smaller price cap carriers. The evidence is clear that such carriers' rates are just and reasonable and already constrained by competition as well as price cap regulation. Even if the FCC granted

35 *See e.g., Id.*, at 14224-25, ¶ 2 (stating that "the Commission fulfills its commitment to provide …[a] *market-based* approach" to special access regulation) (emphasis added); *Id.*, at 14257, ¶ 67 (quoting A*ccess Charge Reform*, First Report and Order, 12 FCC Rcd 15982, 16094 ¶ 262 (1997) ("*Access Charge Reform Order*") (finding that "a market-based approach to access charge reform … ensur[es] that 'our own regulations do not unduly interfere with the development and operation of these markets as competition develops'")).

36 *Access Charge Reform Order*, at 16094, ¶ 262.

the AT&T Petition, which it should not, any decision must exclude mid-sized and smaller price cap carriers, including Iowa Telecom and Valor.

III. ADDITIONAL SPECIAL ACCESS PRICING FLEXIBILITY SHOULD BE ACCORDED TO IOWA TELECOM AND VALOR BECAUSE THERE IS SUBSTANTIAL COMPETITION IN THE MARKETPLACE.

A. Special access services are competitive in the regions served by mid-sized and smaller rural incumbent LECs.

There is extensive competition for special access services where demand exists across the country, including the rural territories served by mid-sized and smaller price cap carriers, like Iowa Telecom and Valor. The Commission has already recognized that some special access services can be constructed economically and that alternative facilities-based competitors operate throughout the country. In a related context, the Commission, in the *Triennial Review Remand Order*, found that competitive carriers face no impairment anywhere across the country for entrance facilities—which is the equivalent to intraexchange special access between incumbent and competitor central offices because such facilities are relatively inexpensive to build, are "widely available" from alternative providers, and have great revenue potential.[37] The Commission even found that the record evidence was *undisputed* "that wholesale alternatives to

[37] *See Unbundled Access to Network Elements; Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, WC Docket No. 04-313, FCC 04-290, ¶ 138 (Feb. 4 , 2005) ("*TRRO*"). Under Section 251(d)(2) of the 1996 Act, the Commission must determine which network elements are subject to unbundling, by evaluating "at a minimum," whether access to proprietary network elements is "necessary," and whether the failure to provide a non-proprietary element on an unbundled basis would "impair" a requesting carrier's ability to provide service. *See* 47 U.S.C. § 251(d)(2). The Commission has found that a requesting carrier is impaired "when lack of access to an incumbent LEC network element poses a barrier or barriers to entry, including operational and economic barriers, that are likely to make entry into a market uneconomic." *TRRO*, ¶ 21. The Commission applies this standard from the perspective of a "reasonably efficient competitor." *Id*. ¶ 22. When the FCC finds that telecommunications carriers are not "impaired" without access to a network element, the Commission concludes that such carriers do not need access to such element in order to compete.

entrance facilities provided by incumbent LECs are widely available."[38] Thus, the Commission already has recognized that a substantial piece of special access services is competitive, economic to construct, and alternative providers exist throughout the country.

The Commission's finding refutes any claim that increased regulation is necessary because carriers can and do deploy their own facilities if they are not satisfied with the incumbent LEC's service or rates. Indeed, as detailed below, Iowa Telecom and Valor face intense competition, which forces these carriers to improve service and constrains conduct and rates.

By way of example, Iowa Telecom faces intense competition for a variety of its services, including local exchange service and switched and special exchange access service. Recognizing the competitive nature of intrastate special access service in Iowa, the Iowa Utilities Board completely deregulated intrastate special access service in 1996.[39] Moreover, the Iowa Utilities Board deregulated all retail local exchange service in fourteen Iowa Telecom exchanges after finding that Iowa Telecom has *less* than 50 percent market share due to vigorous competition from other providers that have constructed their own networks and bypass Iowa Telecom's facilities entirely.[40] In these markets, the Board found that "CLECs have constructed their own networks, which overlap a significant portion of the existing incumbent's local

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38 *TRRO*, ¶ 139.

39 Deregulation of Competitive IntraLATA Interexchange Services; InterLATA and IntraLATA ISDN, Operator Services, and Directory Assistance Services; and Voice Messaging Service, Order Finding Certain Services Subject to Effective Competition and Other Services Not Subject to Effective Competition, Iowa Utilities Board Docket No. INU-95-3 (May 20, 1996). The Iowa Utilities Board had deregulated high-capacity intrastate special access service seven years earlier in Iowa Utilities Board Docket No. INU-88-3.

40 *See* Deregulation of Local Exchange Services in Competitive Markets, Final Decision and Order, Iowa Utilities Board Docket No. INU-04-01 (Dec. 23, 2004).

wireline facilities. This allows the CLEC to furnish local exchange services to customers independent of the incumbent. Overbuilds have been completed by a variety of CLEC's [sic], including cable companies and municipal telecommunications companies."[41] Typically, these competitors have deployed telecommunications facilities as they deployed cable television facilities. In addition, just last month, the Iowa Board tentatively concluded to deregulate an additional fourteen exchanges in Iowa Telecom's territory due to facilities-based competition and overbuilds by other providers.[42] Valor also has a number of Texas exchanges with similar CLEC constructed networks.

Competitive providers in Iowa also offer their services on a wholesale basis, including to Iowa Telecom. Thus, in addition to using their own facilities, competitive providers can purchase special access services from wholesale providers instead of Iowa Telecom's special access services. On a number of occasions, Iowa Telecom has lost telecommunications service bids to competitive carriers due to Iowa Telecom's relative lack of interstate special access pricing flexibility. Such instances have affected not only Iowa Telecom's interstate special access revenue, but also its local exchange, switched access, long distance, and data service revenue. Amongst the competitive options available in Iowa:

- Iowa Network Services, Inc. ("INS") operates a state-wide network that connects many independent incumbent LEC offices. INS also serves as a wholesaler of fiber and leases capacity to Iowa Telecom and other incumbent LECs, and to at least three dozen CLECs in Iowa. INS advertises a range of wholesale services available to carriers, including point-to-point DS1, DS3, OCn, ATM, Frame Relay, and T1, T3, and OCn services.[43] INS also touts

[41] *Id*. at 12.

[42] *See* Deregulation of Single Line Flat-Rate Local Exchange Services in Competitive Markets, Order Initiating Notice and Comment Proceeding, Iowa Utilities Board Docket No. INU-05-02 (May 13, 2005).

[43] *See* Iowa Network Services, *Wholesale Products, available at* http://www.ixcservices.com/Wholesale/default.asp.

its significant fiber presence throughout the state of Iowa.[44] Iowa Telecom leases fiber from INS to supplement its own network.

- Providers of long-haul networks, such as Long Lines, LLC, and Fiberlink Communications, Corp., as well as regional and local networks, traverse Iowa Telecom's territory and pass through many of Iowa Telecom's exchanges. Some carriers have POIs in Iowa Telecom's territory. Long Lines LLC, for example, has proven to be a fierce competitor connecting and providing wholesale support services to some municipal-owned competitive carriers in Iowa Telecom's territory. Yet, most of these carriers do not collocate in any of Iowa Telecom's offices. Iowa Telecom leases point-to-point dark fiber from one of these carriers to supplement its own network.

- Several competitive carriers in Iowa have constructed their own interoffice networks, which include the capabilities to provide special access services, most notably McLeodUSA. These carriers offer their services on a wholesale basis to other carriers. Indeed, Iowa Telecom leases fiber from competitive carriers to build out its own network. For example, Iowa Telecom leases dark fiber from Coon Creek Telephone Company between the two Iowa Telecom exchanges that Coon Creek has overbuilt. Iowa Telecom has at least half a dozen other similar arrangements.

- In addition to the aforementioned list of intramodel competitors, there has been a significant increase in intermodal alternatives in Iowa Telecom's territory. Cable providers, as well as many independent incumbent LECs, have constructed regional distribution systems and provide wireline high capacity services. Furthermore, several electric power companies such as Northwest Iowa Power Cooperative[45] have fiber networks in the area.

- Fixed wireless increasingly is used as another alternative to Iowa Telecom's services. There are fixed wireless providers in Iowa as well as across the country that advertise themselves as alternatives to special access.

- Cable providers such as Cox Cable and Time Warner are active in Valor's Oklahoma and Texas service areas providing data services such as DS1, DS3 and other types of data services.

- Rural incumbent exchange companies XIT, Santa Rosa and Poka Lambro have established CLEC affiliates that operate in small West Texas communities that have completed construction of interoffice networks that connect their CLEC operations with their incumbent network and this network can be used to directly compete with Valor's special access offerings.

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44 *See* Iowa Network Services, *INS State Fiber Optic Map, available at* http://www.ixcservices.com/map_state.asp.

45 *See* <http://www.nipco.com>.

- The Texarkana water department is providing dark fiber solutions to local businesses and schools within Texarkana, Texas

B. The current pricing flexibility triggers should include competitive activity of facilities-based competitors, who do not necessarily meet the collocation based-triggers established by the Commission's rules.

The current FCC pricing flexibility rules do not adequately address the type of competition that mid-sized and smaller price cap carriers like Iowa Telecom and Valor face. Because these carriers face facilities-based competition from providers that do not necessarily collocate in central offices, mid-sized and smaller price cap carriers are often not eligible to receive pricing flexibility under the current collocation-based triggers. While the Commission recognized that the collocation-based triggers are under-inclusive and "may underestimate the extent of competitive facilities within a wire center, because it fails to account for the presence of competitors that have wholly bypassed incumbent LEC facilities,"[46] such triggers now hamstring mid-sized and smaller price cap carriers who face robust competition, but lack the necessary flexibility to respond to such competitive pressures.

As a result, Iowa Telecom, Valor, and other similarly situated carriers, are at a competitive disadvantage because, unlike alternative providers, they are not able to offer contract tariffs and discounted pricing plans for specific customers. Without the necessary flexibility to respond to customer's demands, Iowa Telecom and Valor lose customers to alternative providers such as McLeodUSA. To enable mid-sized and smaller price cap carriers to respond to competitive pressures on an equal footing with other providers, the Commission should revisit its pricing flexibility triggers to ensure that competitive conditions for mid-sized and smaller price

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[46] *Pricing Flexibility Order*, at 14299, ¶ 148.

cap carriers, as well as competition from facilities-based carriers, are fully reflected in the FCC's rules.

C. Pending reforms of intercarrier compensation produce a strong and effective deterrent to unreasonable pricing.

Moreover, at worst, it is premature for the Commission to determine if any modifications to special access regulation are necessary while fundamental changes to broader intercarrier compensation plans are being considered. The Commission should defer action in the instant proceeding until it has adopted regulations in the intercarrier compensation proceeding.

Indeed, under consideration are proposals that would drastically reduce or eliminate carrier charges for switched access services. If adopted, such action would act as a powerful constraint on special access pricing. If carriers can use switched access service at greatly reduced prices, such carriers will be motivated to migrate traffic from special access services to switched access facilities. This action would further constrain incumbent LEC special access prices because incumbent LECs with unreasonably high rates would risk losing special access revenues. Given that special access revenues are now a large percentage of incumbent LEC access revenues, this regulatory change would be a serious deterrent to unreasonable access pricing.

Based on the foregoing, it is clear that AT&T's requested relief is unwarranted. Moreover, the pending intercarrier compensation rulemaking and competitive conditions in the special access market further demonstrates that no special access reform is needed in the long-run because regulations and market forces more than adequately constrain prices.

IV. THE COMMISSION SHOULD MAINTAIN THE CURRENT CALLS STRUCTURE, WITH TARGETED REFORMS TO PROVIDE ADDITIONAL FLEXIBILITY TO INCUMBENT LECS' SPECIAL ACCESS SERVICES.

As demonstrated above, mid-sized and smaller price cap carriers' special access rates, including Iowa Telecom and Valor, are just and reasonable. Nevertheless, the *Notice* asks a series of in-depth questions addressing special access rates and regulations that would be pertinent only if the Commission saw a clear need to re-impose strict rate regulation for these services. None of the purported bases for doing so has any merit. The *Notice* further fails to acknowledge the significant variety of operating conditions among price cap carriers of different sizes. The apparent focus of the *Notice* on competitive conditions in BOC territories only tells part of the story, and is inconsistent with the CALLS regime that at least takes some limited steps to account for the unique needs of smaller and mid-sized carriers.

Bad facts – specifically the *Notice*'s apparent reliance on meaningless service-specific accounting rate of return data – will beget bad rules. Because special access rates are not excessive, there is no basis to unravel decades of increasing reliance on market forces in the special access market. Accordingly, the Commission should reject each of the intrusive and regressive policy issues raised by proponents of the reregulation of special access services.

A. Reregulating price cap carriers would be counter to long-standing Commission polices.

The Commission has long recognized, "[t]he competitive process leads to good economic outcomes: just and reasonable prices, suitable levels of service quality, an appropriate return on investment, an efficient use of scarce resources, the proper rate of technical progress, and an adequate incentive to implement and market new products and services."[47] There is no legal or

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[47] *1995 Price Cap Review Order,* at 8990-91, ¶ 67.

factual justification for reversing this long-standing policy position, which has cultivated a flourishing special access market.

Based on that starting point, the stated objective of price cap regulation is to serve "as a transitional regulatory scheme until the advent of actual competition makes price cap regulation unnecessary."[48] Since the inception of price cap regulation, as discussed in Section I above, the Commission has moved cautiously and incrementally to reduce and rework such regulation to replicate competitive markets more closely and where appropriate, to eliminate regulation altogether. Too often, this process has lagged behind the continuing expansion of alternatives to incumbent special access services. Nonetheless, the FCC has explained that it seeks to provide "progressively greater flexibility … as competition develops."[49]

In stark contrast, the instant *Notice* represents an unsupported proposed shift in direction by the Commission. Beyond the clear detrimental effects on incumbent LECs' operations, investment opportunities, and incentive structures, such extreme reforms could also have significant long-term consequences on the overall sustainability of a robust and competitive special access market. The ability of competitive carriers to invest and compete in the special access market would also be adversely affected.[50] In addition, end-user customers would be adversely affected by a change in policy, because incumbent LECs would lose the ability to craft tailored, customer-specific service plans, and to offer discount plans to better accommodate end-users' particular needs. In the long run, customers would be further affected by foregone capital

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[48] *Id.*, at 8965, ¶ 1.

[49] *Pricing Flexibility Order*, at 14224-25, ¶ 2.

[50] *Access Charge Reform*, at 16094-95, ¶ 263 ("a market-based approach should minimize the potential that regulation will create and maintain distortions in the investment decisions of competitors as they enter local telecommunications markets").

investment and product development that will likely result if there were a significant backtracking in price cap policies.

B. The operational needs of mid-sized and smaller price cap carriers should be incorporated into Commission's price cap policies.

The Commission's original price cap regulatory regime mandated that all of the largest of LECs participate, but explicitly "refrained from mandating price caps for all LECs due in part to our concern that one productivity factor assigned to all carriers could prove unduly burdensome for smaller and mid-sized telephone companies."[51] Throughout the history of price caps, the Commission has repeatedly sought to ensure that its policies provided "greater accessibility to the price cap program" for "mid-sized and small companies."[52] In the *CALLS Order,* the Commission explicitly found that mid-sized and smaller carriers were "reasonably accommodated under the CALLS Proposal."[53] Specifically, mid-sized and smaller carriers were offered a distinct interstate traffic sensitive target rate, significantly higher than the target for larger LECs.[54]

Nonetheless, real-world experience under the CALLS plan suggests that the accommodations for the unique needs and conditions of mid-sized and smaller price cap carriers were insufficient. Iowa Telecom had to resort to a forbearance petition to prevent confiscatory access charge rates, because it determined that even the higher target rate established for mid-sized and smaller carriers "prevent[ed] the company from funding the needed capital investment

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51 *LEC Reconsideration Order*, at 2654, ¶ 138.

52 *Id.*, at 2567, ¶ 144.

53 *CALLS Order*, at 13034, ¶ 173.

54 *Id.*, at 13021-22, ¶ 142.

from internal operations."[55] Valor has faced similar challenges, particularly in its Texas properties, suffering a cycle of single-digit interstate returns, that required the company to seek multiple consecutive low-end adjustments, unprecedented in the history of price cap regulation.[56]

The experience of these mid-sized and smaller price cap carriers under the CALLS regime strongly indicates that any reforms to the price cap rules should more explicitly address mid-sized and smaller price cap carrier conditions. Yet the *Notice* departs from its own prior decisions, and fails to refer to mid-sized and smaller price cap carriers in any meaningful manner.

The Commission should ensure that its price cap policies provide viable solutions for all price cap carriers, and also serve as an incentive for large rate-of-return carriers to transition to incentive-based regulation, which benefits both end-user customers and carriers. The FCC has definitively held that price cap regulation is superior to rate-of-return regulation for both carrier and customer.[57] Yet, regressive reform proposals that would decrease flexibility within the price cap structure further inhibit the ability of large rate-of-return carriers to transition towards, or even consider, incentive-based regulation.[58] Further, the continued failure of price cap policies to reflect fully the needs of mid-sized and smaller carriers further frustrates the Commission's

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[55] *See* Petition for Forbearance of Iowa Telecommunications Services, Inc. d/b/a Iowa Telecom Pursuant to 47 U.S.C. § 160(c), CC Docket No. 01-331, at *iii* (Jan, 18, 2002).

[56] *See, e.g., Valor Telecommunications of Texas, L.P. Petition for Wavier of the 2003 X-factor Reductions Under Section 61.45(b)(1)(i) of the Commission's Rules,* Order, 18 FCC Rcd 11523 (2003) ("*Valor Petition*").

[57] *See*, *Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers,* Second Report and Order and Further Notice of Proposed Rulemaking, 16 FCC Rcd 19613, ¶¶ 4-6 (2001).

[58] *Id.*, ¶¶ 241-259; *Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers,* Report and Order and Second Further Notice of Proposed Rulemaking, FCC 04-31, ¶¶ 68-95 (2004).

overarching goal to encourage the transition of more carriers (and customers) from rate-of-return regulation to price cap regulation and ultimately to deregulation.

C. There is no basis to establish a new productivity factor for special access services.

If it determines any offset is necessary, the Commission should maintain the X-factor established in the *CALLS Order*, which is set equal to inflation rather than tied to productivity. The confluence of market conditions, historical complications, and regulatory trends strongly supports avoiding the burdensome and protracted process necessary to develop a productivity factor, particularly when competitive pressures and the current X-factor achieve the same objective in a less intrusive manner.

Originally, the X-factor was a productivity factor, representing the amount by which LEC productivity exceeded that of the economy as a whole, and consisted of a component based on historical incumbent LEC industry productivity determined on a company-wide (not service specific) basis plus an additional consumer productivity dividend.[59] Through a somewhat tortured history, the Commission adopted a series of "controversial" X-factors, which were challenged by both sides of the industry with mixed judicial results.[60] Throughout this process, the industry failed to reach consensus as to the proper manner in which to establish or calculate a

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59 *Notice,* ¶ 31. If the Commission were to adopt a productivity-based X-factor, there is no basis to reintroduce a consumer productivity dividend component. The consumer productivity dividend was incorporated into the original price cap plan solely to ensure that the "first benefits of price cap regulation would flow to access customers." *1997 Price Cap Review Order*, at 16648, ¶ 8. That purpose has been served, and the consumer productivity dividend would only artificially increase the total productivity factor beyond the Commission's own best projections of a viable measure of industry productivity.

60 *See Access Charge Reform*, Order on Remand, 18 FCC Rcd 14976, 14981-81, ¶ 9 (2003).

productivity-based X-factor. In 1999 alone, commenters proposed productivity-based X-factors ranging from 3.71 percent to 11.2 percent.[61]

In choosing to shift away from a productivity factor after yet another judicial rebuke, the Commission in the *CALLS Order* recognized that the protracted proceedings and uncertainty surrounding the productivity-based X-factor "disrupts business expectations and future investment decisions of both LECs and new entrants."[62] In its place, the Commission adopted a new type of X-factor proposed by the LEC/IXC-backed CALLS Coalition.[63]

Under the CALLS plan, the Commission's X-factor was transformed into a limited transitional mechanism that lowered special access rates for a specified period of time.[64] The special access X-factor was set at 3.0 percent in 2000, 6.5 percent for the next three years, and equal to inflation starting last year. The use of the same term – X-factor – understates the significant differences in approach adopted by the Commission in the *CALLS Order*. First, the X-factor was no longer tied to industry productivity, but rather is a mathematical mechanism to force rate reductions to specific levels.[65] Second, the policy decision was made to treat special access services differently from other price cap offerings through a separate and distinct special

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61 *Notice,* ¶ 33.

62 *USTA v. FCC,* 188 F.3d 521, 530 (D.C. Cir. 1999); *CALLS Order,* at 13034-35, ¶ 174.

63 The elimination and phasing out of a productivity-based X-factor on the federal level is consistent with a growing trend in other price cap plans. States have recognized that the continued growth in competitive opportunities, and the corresponding downward pressure on rates, has largely supplanted the need for a regulatory imposed productivity factor. *See Tenn. Gov. Phil Bredesen (D) Signed a Bill Eliminating,* Communications Daily (Apr. 21, 2005) (new state statute eliminates "productivity offsets in the price cap regulation system prescribed by state law. After four years, rates can rise annually by an amount equal to the preceding year's national gross domestic product price index.").

64 *Notice,* ¶ 34.

65 *CALLS Order,* at 12978, ¶ 40.

access X-factor. Because "special access faces more significant competition than other access services" the CALLS Coalition questioned whether "continued mandated special access reductions will be necessary."[66] Nonetheless, the fact that a special access-specific X-factor was adopted in the *CALLS Order* does not suggest that it would be possible to craft a service-specific productivity factor.[67] To the contrary, a productivity factor is a company-wide measurement that is not even limited to the interstate jurisdiction.[68] The Commission has affirmatively declined to adopt a service-specific productivity factor for individual services, because the X-factor measured the "LEC industry as a whole."[69] Moreover, there are no externally verifiable methods to establish a productivity factor for a subset of incumbent LEC services.

Lastly, the current X-factor is also not indefinite: under the productivity approach, the X-factor remained in place, subject to updates, in perpetuity.[70] The CALLS Coalition members made the conscious policy decision, subsequently adopted by the FCC, to eliminate any further predetermined reductions in special access services – greater than inflation – starting in 2004 in order to encourage additional investment in those areas remaining under price caps.[71] The continued bona fide need for a pro-investment policy towards areas remaining under price caps, consistent with Section 706 of the 1996 Act, strongly suggests maintaining the current X-factor

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66 Reply Comments of the CALLS Coalition, CC Docket No. 96-262, at 58 (Dec. 3, 1999).

67 *Notice*, ¶ 37.

68 *1997 Price Cap Review Order*, at 16686-87, ¶ 110.

69 *1995 Price Cap Review Order*, at 9027, ¶ 146.

70 *CALLS Order*, at 13021, ¶ 141.

71 *Ex Parte Presentation of the CALLS Coalition*, CC Docket No. 94-1, at 15 (Mar. 8, 2000).

equal to the inflation rate. The practical effect of the current X-factor is to cap special access rates in real terms.

Actual market conditions and competitive pricing pressures further corroborate that there is no need to revisit the X-factor. As explained above, category-specific ARMIS rates of return are economically irrelevant and cannot be used to justify additional regulation aimed at decreasing rates, or to determine the need for a productivity factor.[72] The return to a productivity-based X-factor would likely distort market outcomes, and would also be an administrative and legal quagmire for the Commission and the industry.[73]

D. Reinitializing incumbent LEC rates will fundamentally undermine price cap incumbent LECs' incentive to become more productive.

There is no basis for reinitializing special access rates that are already just and reasonable as demonstrated above.[74] In fact, reinitialization based on current market conditions would

[72] *Notice*, ¶ 35.

[73] If the Commission were to decide to revive a productivity-based X-factor, the Commission should consider the adoption of multiple X-factors based on the significant disparity between the operational conditions of the largest price cap carriers and mid-sized and smaller price cap carriers. Prior to the decision in the *CALLS Order* to discard a productivity factor, a number of parties provided substantial evidence to the Commission that "mid-sized price cap LECs cannot sustain the same level of productivity growth that is possible for the nation's largest mandatory price cap LECs." *Reply Comments of ITTA,* at 2, CC Docket No. 94-1 (Apr. 17, 2000). The Missouri Public Service Commission explicitly supported a mid-sized specific X-factor. *Comments of the Missouri Public Service Commission*, CC Docket No. 94-1, at 5 (Jan. 24, 2000). The Commission, however, refrained from adopting a mid-sized X factor in the *CALLS Order* because "the X-factor adopted under the CALLS Proposal is not a productivity offset as past X-factors have been," and moreover, "the CALLS Proposal recognizes and addresses the disparity in subscriber bases and resources by providing higher target rates for mid-sized and low-density price cap LECs." *CALLS Order*, at 13034, ¶ 173. The factual record under the *CALLS Order* as well as the significant disparity in size between the larger (Verizon, SBC, BellSouth) and smaller (Iowa Telecom, Valor) price cap carriers – a far more significant gap today than when price cap regulation was introduced – necessitate a fresh look at the need for a mid-sized approach to productivity-based X-factors.

[74] *Notice*, ¶¶ 59-60.

violate the Act and would do harm to the long-term sustainability of the price cap mechanism. The Commission has recognized that prior calls for reinitialization of price cap rates to achieve an 11.25 percent rate of return, or any other benchmark rate, are merely self-serving claims of special access customers.[75] The Commission dismissed prior calls for re-prescription as a "quarrel fundamentally … with price cap regulation."[76]

The *Notice* further cautions against "the risk of reducing price cap LECs' incentives to operate at minimum cost and to innovate under future price cap plans."[77] Rate prescription would jeopardize the overall sustainability of price cap regulation by denying carriers past efficiencies earned and undercutting carriers' future incentives to reduce costs for fear of subsequent forced rate reductions.[78]

What is more, any attempt to compare results under price caps to arbitrary accounting cost benchmarks and rates of return wrongly perpetuates cost-plus regulation, and needlessly undermines the legitimacy of price cap regulation. One of the key aspects of price cap regulation is to sever the link between accounting costs and rates. As long as rates are set at or below the cap, carriers are free to earn higher returns through efficiency and cost-cutting measures.[79]

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75 *Access Charge Reform*, at 16107, ¶ 291. There is equally no basis to revisit the benchmark for the low-end adjustment under price caps, particularly in light of the few instances in which that backstop mechanism is invoked.

76 *See LEC Price Cap Order,* ¶ 221.

77 *Notice,* ¶ 67.

78 *Notice,* ¶ 67; *see also Access Charge Reform Price Cap Performance Review for Local Exchange Carriers,* Notice of Proposed Rulemaking, Third Report and Order, and Notice of Inquiry, 11 FCC Rcd 21354, 21454-55, ¶ 230 (1996) ("*Access Reform NPRM*").

79 *1995 Price Cap Review Order,* at 8973-74, ¶ 28.

Further, a flash cut in special access rates would be contrary to the Act: the agency previously explained that Section 205(a) precludes rate prescription absent "a finding that current rates are or will be unreasonable," and there is no evidence that special access rates are, or will be, unreasonable.[80] The only evidence of excessive rates presented in this proceeding are meaningless ARMIS accounting rate-of-return data for the largest of price cap carriers. Mid-sized and smaller carriers operate effectively and efficiently within the price cap structure, subject to substantial competition from facilities-based providers.[81] "Represribing a rate of return would also be administratively burdensome," on both the industry and the Commission.[82]

E. There is no evidence that the existing basket and bands structure needs to be revised: if anything, the band structure can be either substantially loosened or eliminated.

Within the price cap structure itself, further flexibility for the delivery of special access services is warranted. The Commission has consistently maintained that it should "[s]ubject[] incumbent LECs to a price cap structure that better replicates the discipline of a competitive marketplace … as we move toward competition itself."[83] The band substructure in the price cap system frustrates the operation of a more market reflective special access regulation.

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80 *LEC Price Cap Order,* ¶ 53.

81 *See supra,* Section III.

82 *Access Reform NPRM*, at 21454-55, ¶ 230. There is also scant evidence to suggest that the current benchmark is inconsistent with current marketplace conditions. The downward trend for the cost of debt is reversing and can be expected to increase for the foreseeable future. Moreover, given the significant increases in competition throughout the country from wireless, competitive carriers, cable providers, and the significant reduction in switched access lines, the return on equity will need to be increased substantially over that which was used to originally establish the 11.25 percent benchmark. As a result, the Commission's analysis in 1990 of concerns vis-à-vis competitive bypass with respect to prescribing an authorized rate of return would need to be revisited. *See Represcribing the Authorized Rate of Return for Interstate Service of Local Exchange Carriers,* Order, 5 FCC Rcd 7507, 7546-48, ¶¶ 204-212 (1990).

83 *1997 Price Cap Review Order,* at 16701, ¶ 150.

Price cap services are currently organized into four baskets of services, and similar services within baskets are then grouped into pricing bands. The subdivision of baskets into bands under current rules significantly limits LEC flexibility to price and design services and to respond to market conditions.[84] The origin of bands was a cautious decision to provide further protection against potential anticompetitive shifting in costs between competitive and noncompetitive services. The belt-and-suspenders baskets and bands mechanisms impair both carriers and customers, yet there is no actual evidence of anticompetitive conduct within the special access basket to justify maintaining the band structure.

Accordingly, the next appropriate incremental step in the Commission's continued relaxation of price cap restrictions in light of significant competitive inroads is to relax the restrictions within the special access basket by eliminating all pricing bands and associated restrictions. By doing so, incumbent LECs would be afforded the same flexibility as their competitors enjoy, subject only to the overall cap on the special access basket. This will enable incumbent LECs to rationalize pricing to better meet customer demand and changing technologies.[85]

With that perspective, any further balkanization of special access services within the special access basket is contrary to market realities and the optimal operation of a price cap system.[86] There is, therefore, no basis to create separate bands or categories for retail/wholesale, DS1/DS3, broadband services, or any individual special access rate elements.

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[84] *See LEC Price Cap Order,* ¶¶ 200-01.

[85] *See Price Cap Performance Review of Local Exchange Carriers,* Second Further Notice of Proposed Rulemaking, 11 FCC Rcd 858, 901, ¶ 93 (1995) ("[c]onsolidation of service categories would allow a LEC more pricing flexibility").

[86] *Notice*, ¶¶ 50-52.

F. The FCC must retain the low-end adjustment mechanism to ensure that price cap regulation remains constitutional.

The FCC most recently concluded in the *Pricing Flexibility Order* that the low-end adjustment mechanism was essential for any services remaining under price cap regulation.[87] There is no basis to revisit that determination, and the Commission should adopt its tentative conclusion to maintain a slightly modified version of the backstop mechanism.[88]

First, a "low-end adjustment is not likely to have a significant practical effect because it has been rarely invoked in the past."[89] Second, in the limited instances in which a carrier is eligible for a low-end adjustment, the mechanism provides only prospective relief for a single year. Such relief is further limited to ensure that a carrier receives only a 10.25 percent intestate return company-wide in the next year.[90] Third, the low-end adjustment is demonstrably pro-consumer, because carriers earning below a 10.25 percent return will likely lack the necessary revenues to "attract capital and to provide services," and risk potential service quality degradation and other operational complications.[91] Fourth, the low-end adjustment serves as a specific protection for small price cap carriers and "address[es] any heterogeneity that may exist among price cap LECs."[92]

Lastly, absent the relatively simple procedure available in the low-end adjustment, carriers with disproportionately low returns would be faced with no clear mechanism to ensure that rates

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87 *Pricing Flexibility Order,* at 14306-07, ¶ 166.

88 *Notice,* ¶ 45.

89 *CALLS Order,* at 13038, ¶ 182.

90 *See* 47 C.F.R. § 69.731.

91 *Notice,* ¶ 45.

92 *1997 Price Cap Review Order,* at 16703-04, ¶ 157.

are not confiscatory. Specifically, carriers would be forced either to seek an above-cap filing – a burdensome and seldom (if ever) used process for both carrier and Commission staff – or an equally resource-intensive federal takings lawsuit challenging the constitutionality of the carrier's rates under price caps.[93] Refusing to allow an adjustment to rates when the interstate return is unreasonably low would deprive the incumbent LEC of property without due process of law.

The FCC should, however, modify the manner in which the low-end adjustment mechanism is applied in conjunction with other components of the price cap structure. Specifically, in its implementation of the X-factor and the low-end adjustment, the Commission has flipped the proper order of these mechanisms, and should on a going forward basis apply the X-factor first, and then incorporate a low-end adjustment, if necessary. This would allow both functions to serve their intended purpose.

Currently, the low-end adjustment is treated as an exogenous cost, even though unlike all other exogenous costs, the low-end adjustment is affirmatively taken out of the revenue base the next year. This results in X-factor reductions applying to the temporary low-end adjustment, effectively foreclosing the possibility that the low-end adjustment will serve its intended purpose (rates are not actually set to earn 10.25 percent). If they were reversed, carriers would first apply any X-factor reductions, and then incorporate the low-end adjustment, setting the X-factor reduced rates at a level to earn a 10.25 percent return for the following year. Because the low-end adjustment is subsequently removed from price caps prior to the next year's filings, the X-factor's permanent reductions from the prior year are unaffected. The FCC should apply its rules to ensure that both the X-factor and low-end adjustment co-exist in an equitable non-confiscatory

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93 *CALLS Order*, at 13037-38, ¶ 181; *Pricing Flexibility Order*, at 14306-07, ¶ 166.

manner. Valor's cycle of low returns, and the inability of the currently configured low-end adjustment to break this cycle, provides clear evidence of a need to alter the current relationship between the two mechanisms.[94]

G. The FCC should refuse to re-establish sharing, a device that was abandoned long ago because it undermined price caps' incentive system.

Sharing was eliminated in 1997 because it "severely blunts the incentives of price regulation."[95] The *Notice* reaffirms that finding, concluding that it would be inappropriate to reintroduce a sharing mechanism into price caps for special access services.[96]

The FCC previously found that "eliminating the sharing requirement will increase the incentive of incumbent LECs to become more productive."[97] Beyond severely affecting the efficiency goals underlying price cap regulation, the reintroduction of this vestige of cost-plus regulation could also hamper future efforts to deregulate special access services.[98] Specifically, the Commission previously found that the elimination of sharing would "enable us to deregulate competitive services while noncompetitive services remain under regulation."[99] There is no basis to revisit that conclusion, or further limit carriers' flexibility and efficiency incentives under price caps.

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94 *See, e.g., Valor Petition.*

95 *See Notice,* ¶ 43; *1997 Price Cap Review Order,* at 16650, ¶ 14.

96 *See Notice,* ¶ 44.

97 *1997 Price Cap Review Order,* at 16650, ¶ 14; *see also 1995 Price Cap Review Order,* at 9047, ¶ 191 ("the sharing mechanism deprives LECs and their customers of the full benefits of lower prices and improved efficiency that a pure price cap scheme can offer.").

98 *1997 Price Cap Review Order,* at 16701, ¶ 151 ("sharing might be a serious impediment to deregulation").

99 *Id.,* at 16650, ¶ 14.

H. A "g" factor is a poor fit to the special access market and should not be adopted

The inclusion of a "g" factor into price caps for special access services would be unnecessary, duplicative, and inconsistent with market conditions. A "g" factor is ill equipped and inappropriate for the competitive conditions in the special access market and is aimed to resolve an asserted deficiency in the current system that does not actually exist.

The Commission developed a "g" factor to respond to a specific inconsistency in the manner in which incumbent LECs recovered interstate loop costs: specifically, that the incumbent LECs' carrier common line charge recovered non-traffic sensitive costs from interexchange carriers, on a per-minute basis.[100] The "g" factor modified the price cap for common line services to ensure that IXCs were direct beneficiaries of any increase in per-minute demand.

Special access rates, however, are generally recovered on a non-traffic sensitive basis, unlike the implicit carrier common line charge. The disparity in cost recovery justifying the "g" factor is not present in this case. Nor is there any evidence that growth in special access lines is divorced from growth in special access costs. The reliance on ARMIS data in the *Notice* suggests that special access revenues have grown exponentially and disproportionately in comparison to ARMIS special access costs. As demonstrated in Section II above, however, ARMIS data cannot be used in this manner. In truth, special access revenues and costs have grown proportionately, both driven by the substantial increase in demand for such services. The inclusion of a "g" factor would also raise substantial administrative concerns, because of the

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[100] *See LEC Price Cap Order*, at 6794.

significant risk that any X-factor adopted by the Commission would double-count the efficiencies captured by a "g" factor.[101]

[101] *Notice*, ¶ 38.

V. CONCLUSION

For the foregoing reasons, Iowa Telecom and Valor request that the Commission provide further flexibility to price cap carriers' delivery of special access services based upon the substantial growth in special access services and the equally significant development of greater special access competition. These market-driven developments require market-based deregulatory efforts. First, the Commission's pricing flexibility rules should be expanded to ensure that incumbent LECs have the ability to compete effectively in those areas in which facilities-based competition has developed. Second, the Commission should eliminate the band structure within the special access basket to provide greater flexibility for incumbent LEC pricing and marketing of services within the price cap structure. Lastly, the Commission should reject any effort to revert back to command-and-control style regulation of special access services.

Respectfully submitted,

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