

BEFORE THE  
Federal Communications Commission  
WASHINGTON, D.C.

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

**COMMENTS OF TIME WARNER TELECOM**

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**COMMENTS OF TIME WARNER TELECOM**

Time Warner Telecom (“TWTC”), by its attorneys, hereby files comments in response to the Notice of Proposed Rulemaking<sup>1</sup> in the above-captioned proceeding.

**I. INTRODUCTION**

In the approximately six years since the adoption of the Commission’s pricing flexibility rules for special access, it has become all too clear that those rules are seriously flawed. As the Commission has itself acknowledged, the triggers for granting special access pricing flexibility were improperly designed. They rely on incorrect product markets by, for example, treating loops of every capacity as belonging to the same market. They rely on an incorrect geographic market, the MSA, which the Commission has itself criticized in its unbundling orders as inappropriate for analyzing either loops or transport (the same facilities used to provide special access). They also rely on proxy triggers for competitive deployment of loops and transport,

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<sup>1</sup> See *Special Access Rates for Price Cap Local Exchange Carriers; AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, Order and Notice of Proposed Rulemaking, 20 FCC Rcd 1994 (2000) (“*Special Access NPRM*”).

based on the number of fiber-based collocations, that can be satisfied even in MSAs in which no loops have been deployed and few transport facilities have been deployed.

In light of these shortcomings, it should be no surprise that the ILECs have been freed from price cap regulation in areas in which they continue to have market power. Academic commentators, end user customers, and carriers have all concluded that the ILECs are exploiting that market power by unilaterally raising the month-to-month and multiple month term plan special access rates in the many areas in which they have received Phase II pricing flexibility. Even where incumbents have held special access rates steady in Phase II areas, they have effectively increased rates because their average costs have been declining due to substantial increases in economies of scale.

The incumbents respond by asserting, among other things, that they offer discounts on these rates to customers willing and able to commit to volume and term agreements. But such commitments themselves demonstrate the manner in which the ILECs exercise market power. For example, while the volume/term agreements include discounts off of ILEC special access rates that are tariffed (but not subject to price caps), the ILECs can, and have, raised those underlying rates, thus limiting (or even eliminating) the discount. Moreover, the incumbents use volume discounts as a means of disciplining and limiting competition in the provision of special access. For example, the incumbents effectively condition the availability of discounted rates in geographic areas and for products without competition on the customer purchasing special access from the incumbent in geographic areas and for products that are competitive. By tying offers of competitive services to offers of monopoly services, the incumbents prevent customers from benefiting from lower costs and innovation in competitive markets.

Unfortunately, the incumbents' opportunities to engage in this kind of behavior are only growing. While the availability of unbundled loops and transport has constrained the incumbents' ability to increase prices for the equivalent special access offerings, the Commission has eliminated unbundling for packet-switched loops and more recently cut back on the availability of even DS1 and DS3 loops and transport. In addition, the proposed acquisition of AT&T by SBC and of MCI by Verizon threaten to eliminate AT&T and MCI, probably the two largest suppliers of competitive special access, as competitive wholesalers of special access. If those acquisitions were permitted, AT&T and MCI would clearly no longer compete in the SBC and Verizon regions respectively. But the likely coordinated effects of the two mergers would likely cause the two firms to withdraw as competitive wholesalers out-of-region as well.

As the Commission recognizes in the NPRM, there is both an immediate need to limit the incumbents' ability to exploit their market power in the provision of special access and a longer-term need to reassess the regulatory regime for special access. The immediate need to constrain incumbent abuse of market power can be most efficiently addressed by simply eliminating Phase II pricing flexibility for services over which the incumbents retain the ability to unilaterally increase prices. This group of services includes, at the very least, all DS1, DS3 and Ethernet special access services. These services should be subject to price caps, and their rates should be reinitialized, to the extent possible, at the levels that would have applied had they never been removed from price caps. By requiring that these services are available at a "backstop" rate set under price caps, the Commission would go a long way toward limiting the incumbents' ability to exploit market power by unilaterally raising rates and engaging in unlawful tying. At the same time, by retaining Phase I flexibility, the Commission would honor the commercial

expectations of companies that have already entered into volume/term agreements and that would like to continue operating pursuant to those agreements.

Finally, the Commission must of course conduct a longer-term review of its pricing flexibility regime. This is a more complex undertaking than the adoption of interim measures for limiting abuse of market power, and the Commission should be sure to undertake a thorough study of appropriate market definitions as well as the appropriate means of measuring competition. Moreover, any such analysis must take into account the effects of the proposed Bell-long distance carrier mergers as well as any conditions that may be placed on those mergers.

## **II. THE EXISTING REGULATORY FRAMEWORK FOR SPECIAL ACCESS PRICING FLEXIBILITY IS FATALY FLAWED**

The existing triggers for granting pricing flexibility for special access fail in their most basic objective: ensuring that rate regulation is eliminated only where competition can reliably discipline incumbent LEC pricing behavior. Because the current regime is so poorly designed, it yields many false positives. That is, it causes the incumbents to be relieved of regulation, most importantly price cap regulation, in product and geographic markets in which the incumbents continue to possess substantial and persisting market power.

*First*, the existing pricing flexibility rules are based upon incorrect assumptions about the impact on wholesale and retail special access prices of extremely limited deployment of facilities by competitors. For example, to obtain Phase II pricing flexibility for interoffice transport throughout an MSA, an ILEC need only show that one collocated carrier using non-ILEC interoffice transport is present in 50 percent of the wire centers in an MSA or in wire centers

representing 65 percent of the ILEC's transport revenues in an MSA.<sup>2</sup> To obtain Phase II pricing flexibility for special access channel terminations throughout an MSA, an ILEC need only show that one collocated carrier using non-ILEC transport is present in 65 percent of the wire centers in an MSA or in wire centers representing 85 percent of the ILEC's channel termination revenues in the MSA. *See id.* at 150. Even on their own terms, these tests make little sense. As one economist who has studied special access notes, “[t]he presence of a collocator with one line serving one customer contributes as much to the metrics as does a collocator with 100 lines serving 5,000 customers.”<sup>3</sup> Even the Commission has come to agree that the revenue-based collocation trigger is an inaccurate measure of competitive deployment.<sup>4</sup>

As a result of these triggers, pricing flexibility has been granted in areas where few competitors have actually deployed facilities. For example, BellSouth was granted pricing flexibility in most of the major MSAs in the south, yet BellSouth estimates that across its 9 state region, only 2,200 buildings are served by non-ILEC connections.<sup>5</sup> By comparison, in Florida alone, Bellsouth provides 40,000 DS1 special access loops to CLECs. *Id.* As demonstrated

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<sup>2</sup> *See Access Charge Reform, et al.*, Fifth Report and Order and Further Notice of Rulemaking, 14 FCC Rcd 14221 ¶¶ 148-49 (1999) (“Pricing Flexibility Order”).

<sup>3</sup> Noel D. Uri and Paul R. Zimmerman, *Special Access Service and its Regulation in the United States*, 6 Journal Of Policy, Regulation, and Strategy for Telecommunications, 122, 157 (2004) (“Zimmerman”).

<sup>4</sup> *See Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, Report and Order and Order on Remand, 18 FCC Rcd 16876, ¶ 397 (2003) (“TRO”), *vacated in part, United States Telecom. Ass’n v. FCC* 359 F.3d 554 (D.C. Cir. 2004) *cert. denied*, 125 S. Ct. 313 (2004) (“The record indicates that incumbent LECs have qualified for special access pricing flexibility in numerous MSAs throughout their regions, almost exclusively by meeting the triggers based on special access revenues. Because the revenue trigger requires only a single collocated competitor and the purchase of substantial amounts of special access in a concentrated area, this test provides *little indication* that competitors have self-deployed alternative facilities, or are not impaired outside of a few highly concentrated wire-centers.”) (emphasis added).

<sup>5</sup> *See ex parte* presentation of BellSouth at 4, attached to Letter of Glenn T. Reynolds, Vice President, Federal Regulatory, BellSouth, to Marlene H. Dortch, Secretary, FCC, CC Dkt. No. 01-338 (filed Aug. 18, 2004).

below, this limited competitive presence has little effect on ILEC pricing behavior. Moreover, as one commenter notes, the maps supplied by the RBOCs in the *Triennial Review Remand* proceeding indicate that large swaths of MSAs outside of downtown areas where pricing flexibility has been granted contain no facilities deployed by competitors at all. In fact, “in many instances, buildings where CLECs find it necessary to purchase RBOC special access lie right along CLEC fiber routes.”<sup>6</sup> Clearly, the current pricing flexibility rules have served as a poor proxy for determining the availability of competitive transmission facilities throughout an MSA.

*Second*, the special access regulatory framework fails to account for important distinctions among special access product markets. For example, the current rules differentiate only between (1) connections to customer premises (channel terminations) and (2) other dedicated transmission facilities. Yet, as the Commission has concluded over and over in the UNE proceedings, the differences in revenue opportunities among different levels of capacity (*e.g.*, between a DS1 and OC48) dictate that certain capacities are suitable for competitive supply, while others are not.<sup>7</sup> Stated slightly differently, the fact that a competitive carrier can deploy its own fiber loops to serve customers demanding OC48 connectivity in no way demonstrates that a competitor could deploy its own fiber loops to serve customers demanding only a DS1 level of connectivity. This failure to incorporate capacity into the pricing flexibility analysis leads to numerous false positives; assumptions that a service is subject to competition when in fact it is not.

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<sup>6</sup> Reply Declaration of Susan M. Gately, attached to Reply Comments of Ad Hoc Telecommunications Users Committee, WC Dkt. No. 05-65 at 22 (filed May 10, 2005).

<sup>7</sup> See *e.g.*, *Unbundled Access to Network Elements, et al.*, Order on Remand, 20 FCC Rcd 2533, ¶ 149 (2005) (“*TRRO*”); *TRO* ¶ 298.

*Third*, the existing pricing flexibility rules also are based on an improper and overly broad geographic market definition.<sup>8</sup> The existing rules rely on MSAs as the appropriate geographic market to scrutinize competitive deployment. This is so even though the entry barriers and revenue opportunities associated with deploying transmission facilities vary substantially within different parts of the same MSA. As the Commission has held, “due to the wide variability of market characteristics within an MSA, MSA-wide conclusions would substantially over-predict the presence of actual deployment, as well as the potential ability to deploy.” *TRRO* ¶ 82. Indeed, the Commission has flatly rejected MSAs as geographic areas for assessing competition in the provision of local transmission services.<sup>9</sup> Rather, as Professor Farrell explains, the most appropriate market for special access loops is likely to be “extremely localized” since “a business located in a certain building...is unlikely to substitute special access to a different building in response to a small but significant and non-transitory increase in the price of special access to its building.”<sup>10</sup> The Commission has agreed, noting that a building-specific test “could assess variations in impairment far more subtly than could a wire-center or MSA-based approach.” *TRRO* ¶ 155.

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<sup>8</sup> Even in the *Pricing Flexibility Order* itself, the Commission recognized that a more granular geographic analysis “might produce a more finely tuned picture of competitive conditions.” *Pricing Flexibility Order* ¶ 74.

<sup>9</sup> *See id.* (“Mass are comprised of communities that share a locus of commerce, but not necessarily common economic characteristics as they relate to telecommunications facility deployment...Thus even if transport facilities are widely deployed throughout part of an MSA...it would be inappropriate to infer a lack of impairment on every route in every part of that MSA because economic conditions may vary significantly from one part of an MSA to another...”); *TRO* ¶ 402 (holding that making impairment decisions on an MSA-basis result in an “over-inclusive” impairment analysis).

<sup>10</sup> Declaration of Joseph Farrell ¶ 10, attached to Opposition of Global Crossing, WC Dkt. No. 05-65, (filed Apr. 25, 2005) (“*Global Crossing Opposition*”).

*Fourth*, the use of collocations as proxies for competitive entry is clearly inappropriate.<sup>11</sup> The problem with relying on collocations as a proxy for competition is most obvious with regard to loops. This is so because collocations can be deployed where there is absolutely no competitive loop deployment and loop deployment can occur in locations distant from collocations. When a competitor collocates in an ILEC wire center, it does so primarily for the purpose of gaining access to the ILECs special access channel termination circuits or unbundled loops, *not* for constructing its own loop facilities. For example, there are many carriers such as Cbeyond and Nuvox that collocate<sup>12</sup> in ILEC wire centers in order to serve their customers nearly exclusively via DS1 loops.<sup>13</sup> Since DS1s cannot generally be competitively supplied (*see TRRO* ¶ 170), these carriers must satisfy their demand with ILEC facilities. *See Nuvox Comments* at 13. Indeed, Nuvox has deployed over 280 collocation arrangements without constructing a single DS1 loop. *See id.* at 2. Conversely, for carriers like TWTC that do construct loop facilities in certain circumstances, collocations are a poor proxy for determining where deployment is possible. For example, as the Commission has recognized, competitive carriers generally deploy facilities to commercial buildings from splice points in their fiber

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<sup>11</sup> The Commission admitted in the pricing flexibility order itself that collocation-based triggers might present an inaccurate picture of competitive loop deployment. *See Pricing Flexibility Order* ¶ 103 (“As a number of parties indicate, a competitor collocating in a LEC end office continues to rely on the LEC’s facilities for the channel termination between the end office and the customer premises, at least initially, and thus is susceptible to exclusionary pricing behavior by the LEC, and so collocation by competitors does not provide direct evidence of sunk investment by competitors in channel terminations between the end office and the customer premises.”). The Commission chose to use such a test merely because “it appear[ed] to be the best option available . . . at this time.” *Id.*

<sup>12</sup> *See* Reply Comments of Cbeyond, WC Dkt. Nos. 04-313 *et al.*, at 3 (filed Oct. 19, 2005); Comments of Nuvox, WC Dkt. Nos. 04-313 *et al.*, at 2 (filed Oct. 4, 2005) (“*Nuvox Comments*”).

<sup>13</sup> *See ex parte* presentation of Cbeyond at 4, attached to Letter of Patrick J. Donovan, Counsel, Cbeyond, CC Dkt. No. 01-338 (filed Sept. 8, 2004); *ex parte* presentation of Nuvox at 6, attached to Letter of Michael H. Pryor, Counsel, Nuvox, to Marlene H Dortch, Secretary, FCC, WC Dkt. Nos. 01-338 (filed Aug. 19, 2004).

transport rings, (*see TRRO* ¶ 153) which may be many miles away from the closest end-office where the carrier has collocated.

Despite its misgivings regarding the accuracy of its triggers, the Commission was willing to establish its pricing flexibility framework in part because it believed the existence of separate affiliate safeguards in the in-region long distance business would limit the ILECs' opportunities to discriminate against independent IXCs. Indeed, the Commission assumed that special access inputs would be most crucial to IXCs not CLECs: "[W]e note that these services generally are purchased by IXCs." *Pricing Flexibility Order* ¶ 155. *See also id.* ¶ 142. The Commission did not even consider the possibility that competitive providers of local exchange and special access services would themselves purchase loops and transport from ILECs under special access tariffs. In explaining why ILECs would be unlikely to exploit pricing flexibility to discriminate unreasonably among special access customers, the Commission emphasized that IXCs are large businesses that purchase special access and "generate significant revenues for the incumbent and are not without bargaining power with respect to the incumbent." *Id.* Moreover, the FCC also assumed that ILECs would sell special access to competitors only in markets where the ILECs' own downstream retail offerings were subject to separate affiliate requirements.<sup>14</sup> Throughout the *Pricing Flexibility Order*, the Commission referred to ILEC in-region long distance offerings as provided through "affiliates" (*see e.g., id.* ¶¶ 129, 134-5). The FCC even established special protections against ILEC price discrimination in the provision of special access that are only

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<sup>14</sup> For example, the FCC assumed that BOCs would be providing in-region long distance through Section 272 2 affiliates "[o]nce the Commission grants BOCs permission, pursuant to section 271 of the Act, 47 U.S.C. § 271, to provide in-region long distance services, they are required to offer those services through separate affiliates." *Id.* n.345.

relevant where the ILEC provides retail service through a separate affiliate.<sup>15</sup> Of course, no such protections apply in the local and special access markets in which ILECs provide service on an integrated basis. Even for IXC, the assumption that separate affiliate requirements could provide protection against anticompetitive behavior is disappearing. As Commissioner Martin has noted, the Commission has permitted separate affiliates to sunset in many states<sup>16</sup> without any evaluation of how the loss of these safeguards will impact competition.<sup>17</sup>

The proposed SBC-AT&T and Verizon-MCI mergers offer further evidence that the FCC's reliance on collocation as a measure of sunk cost is misplaced. For example, if the Bell companies were permitted to acquire the IXCs' in-region assets, the merged companies would of course retire the in-region collocations and transition the IXCs' circuits to the Bells' existing infrastructure. This would mean that many collocations relied upon by the ILECs to meet the pricing flexibility triggers would be eliminated. Notwithstanding this change, the ILECs would continue to be freed from regulation since there is no mechanism under the current rules to

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<sup>15</sup> See *id.* ¶ 129 (prohibiting an ILEC from offering a contract tariff to an affiliate unless and until an unaffiliated customer first purchases service pursuant to the contract).

<sup>16</sup> See *Section 272 Sunsets for Verizon Communications Inc. in the State of Vermont by Operation of Law on April 17, 2005 Pursuant to Section 272(f)(1)*, Public Notice, 20 FCC Rcd 8116 (2005); *Section 272 Sunsets for Verizon Communications Inc. in the State of Rhode Island By Operation of Law On February 24, 2005 Pursuant to Section 272(f)(1)*, Public Notice, 20 FCC Rcd 4072 (2005); *Section 272 Sunsets for SBC in the States of Arkansas and Missouri by Operation of Law on November 16, 2004 Pursuant to Section 272(f)(1)*, Public Notice, 19 FCC Rcd 23112 (2004); *Section 272 Sunsets for Verizon Communications, Inc. in the State of Massachusetts by Operation of Law on April 16, 2004 Pursuant to Section 272(f)(1)*, Public Notice, 19 FCC Rcd 7588 (2004); *Section 272 Sunsets for SBC in the States of Kansas and Oklahoma by Operation of Law on January 22, 2004 Pursuant to Section 272(f)(1)*, Public Notice, 19 FCC Rcd 1747 (2004); *Section 272 Sunsets for SBC in The State of Texas by Operation of Law on June 30, 2003 Pursuant to Section 272(f)(1)*, Public Notice, 18 FCC Rcd 13566 (2003) (“*Texas Order*”); *Section 272 Sunsets for Verizon in New York State by Operation of Law on December 23, 2002 Pursuant to Section 272(f)(1)*, Public Notice, 17 FCC Rcd 26864 (2002).

<sup>17</sup> See e.g., *Texas Order*, Concurring Statement of Commissioner Martin, (“[M]any parties, including the Texas Public Utilities Commission, contend that it is premature to lift the separate affiliate safeguards provided by section 272. As I have said before, I would have preferred, that we affirmatively set forth, in a separate Commission order, our analysis and justification for granting the relief we announce in today’s public notice rather than remain silent.”).

“undue” pricing flexibility determinations.<sup>18</sup> Failure to amend the pricing flexibility rules to take into account the loss of these collocations violates the basic principle that an agency must adjust its rules to account for changed circumstances.<sup>19</sup> Indeed, to ignore the impact of these mergers would squarely contradict the entire rationale of the pricing flexibility regime: to determine the extent to which competitors have made *irreversible* sunk investments in facilities.

Even more tellingly, as opponents of the SBC-AT&T and Verizon-MCI mergers have demonstrated, neither the combined SBC-AT&T nor the combined Verizon-MCI is likely to offer special access as a competitive wholesale offering out-of-region. Instead, the merged companies are likely to use their out-of-region collocations to provide only *retail* enterprise service. This is so because of the substantial incentive for collusion created by the merger.<sup>20</sup>

The likelihood of collusion is strong in situations such as the local special access market where there are existing territorial divisions, high market concentrations, significant barriers to entry, and entry into the other’s territory is easy to detect.<sup>21</sup> Accordingly, it is likely that the merged

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<sup>18</sup> The Commission of course faces the same problem with respect to its collocation-based unbundling triggers adopted in the *TRRO*. Two petitions for reconsideration of that order have been filed arguing that the Commission must take these mergers into account in *See Birch Telecom Inc. et al., Petition for Reconsideration, WC Dkt Nos. 04-313 et al., at 23-24 (filed Mar. 28, 2005); CTC Communications Corp. et al., Petition for Reconsideration, WC Dkt Nos. 04-313 et al., at 6-7 (filed Mar. 28, 2005).*

<sup>19</sup> *See Geller v. FCC, 610 F.2d 973, 979 (D.C. Cir. 1979)* (noting that the agency has an obligation to re-examine its regulations when changed circumstances alter the facts upon which the regulations were premised).

<sup>20</sup> *See Declaration of Simon Wilkie, ¶ 30, attached to Opposition of Cbeyond et al., WC Dkt. No. 05-65, (filed Apr. 25) (“Wilkie Declaration”)* (“This type of tacit collusion is orchestrated by a simple strategy: ‘I will not undercut your special access rates to competing carriers in your territory if you do not undercut my special access rates to competing carriers in my territory’ The strategy is consistent with the behavior of SBC and Verizon in other markets.”); *ex parte* presentation of Global Crossing at 20, attached to Letter of Teresa Baer, Counsel, Global Crossing, to Marlene H. Dortch, Secretary, FCC, WC Dkt. Nos. 05-65 *et al.*, at 20 (filed June 2, 2005) (“*Global Crossing ex parte*”) (“Out-of-region SBC and Verizon will become each other’s largest customer, increasing the likelihood of mutually preferential treatment”).

<sup>21</sup> *See DOJ/FTC Horizontal Merger Guidelines §§ 2.1-2.12.*

companies' out-of-region collocations will no longer be used as an input for competitive wholesale service even if it would be efficient for a third party competitor to use them for this purpose. Thus, even if collocations were otherwise a sound proxy for special access competition (which they are not), the proposed mergers fundamentally undermine any reliance on fiber-based collocations in the future for this purpose.

*Finally*, in adopting its pricing flexibility rules, the Commission relied on the key assumption that incumbent LECs would not be able to sustain price increases in areas in which competitors have established fiber-based collocations because the competitors would simply expand their entry to undercut the incumbents' prices. But this assumption is clearly incorrect, especially with respect to high capacity loops. This is so in large part because of the substantial entry barriers which prevent competitive carriers from constructing facilities in all but the densest urban areas.<sup>22</sup> As the Commission has repeatedly found, these barriers include large sunk costs, the ILECs' first mover advantages, the unwillingness of many customers to wait until a CLEC has completed its construction, the inability to gain access to rights-of-way and the ILECs' economies of scale and cost advantages.<sup>23</sup>

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<sup>22</sup> See *TRRO* ¶ 154. See *id.*, Statement of Chairman Powell at 2 (“the record and our analysis demonstrated that competitors still depend[] significantly on [incumbent loops and transport] in the overwhelming majority of markets.”) Commissioner Abernathy reiterated this point and emphasized that the relevant entry barriers made it “uneconomic” to construct DS1 loops, the most widely use level of connectivity for serving the small and medium business market, in “the vast majority” of cases. See *TRRO*, Statement of Commissioner Kathleen Q. Abernathy at 1.

<sup>23</sup> See *TRRO* ¶ 151 (“In addition to the substantial fixed and sunk costs involved in deploying competitive fiber, competitive LECs also face substantial operational barriers to constructing their own facilities. As we found in the Triennial Review Order, the construction of local loops generally takes between six to nine months absent unforeseen delay...Often these delays are attributable to problems in securing rights-of-ways from local authorities in order to dig up streets prior to laying fiber, including lengthy negotiations with local authorities over the ability to use public rights-of-way and obtaining building and zoning permits. Moreover, commenters note that many local jurisdictions impose construction moratoriums which prevent the grant of a franchise agreement to construct new facilities in the public rights-of-way.”); *TRO* ¶¶ 87-91.

Indeed, as a result of these formidable obstacles to deployment, competitive providers of high capacity loops have constructed facilities to only a tiny fraction of commercial buildings nationwide. For example, in the most recent RBOC “*UNE Fact Report*,” the RBOCs admit that CLECs only serve 32,000 buildings<sup>24</sup> out of between 739,000 and 3 million commercial buildings nationwide. See *TRRO* ¶ 157. The Commission came to a similar conclusion in the *Triennial Review Order*, in which it noted that only “3% to 5% of the nation’s commercial office buildings are served by competitor-owned fiber loops” *TRO* n. 856. The largest competitive supplier, AT&T, provides fully 7,000<sup>25</sup> high capacity loops to commercial buildings. Although the number commercial buildings served by MCI is unavailable, it is generally understood to be one of the largest, if not the second largest supplier of high capacity loops.<sup>26</sup> By contrast, Time Warner Telecom and XO have only 5,281<sup>27</sup> and 2,435 connections to commercial buildings respectively. See *UNE Fact Report* at III-4. Of course, once the current RBOC mergers are consummated and MCI and AT&T’s high capacity loops migrate to SBC and Verizon’s networks, the RBOCs’ market power over high capacity loops will only intensify.

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<sup>24</sup> See *UNE Fact Report* 2004, filed by Qwest, Verizon, SBC and BellSouth, WC Dkt. Nos. 04-313 *et al.*, at III-4 (filed Oct. 4, 2004) (“*UNE Fact Report*”).

<sup>25</sup> See *Opposition of SBC Communications*, RM No. 10593 at 14 (filed Dec. 2, 2002).

<sup>26</sup> MCI has closely guarded the number of buildings to which it provides lit fiber. However, evidence in the record indicates that it is a substantial provider of loop facilities. For example, a study of the Chicago market by Broadwing indicates that MCI actually provides the most Type I circuits with 253 lit buildings, while AT&T is second at 236 lit buildings. The third largest is XO at only 72. See *Declaration of Mark Pietro* ¶ 10, attached to *Opposition of Broadwing et al.*, WC Dkt. No. 05-65 (filed Apr. 25, 2005) (“*Broadwing Opposition*”).

<sup>27</sup> See *Quarterly Report of Time Warner Telecommunications Inc.* at 21 (March 2005) (“*TWTC 10-Q*”).

Accordingly, contrary to the Commission's assumption in the pricing flexibility order,<sup>28</sup> competitive carriers cannot quickly increase supply to counter high ILEC special access prices. In other words, the combination of very high entry barriers and low CLEC capacity means that the elasticity of supply for high capacity loops is extremely low, enhancing the ILEC's market power.<sup>29</sup> Indeed, because of these barriers to entry, TWTC can only construct loops to less than 1,000 buildings per year.<sup>30</sup>

Nor can cable modem or wireless service provide viable alternatives to special access services. *See Special Access NPRM* ¶ 85. In the *TRRO*, the Commission held that cable companies' Hybrid Fiber Coax (HFC) networks generally are not deployed in the same geographic areas as the businesses who demand DS1 or higher capacity service. *TRRO* ¶ 193. Moreover, cable modem service apparently does not include some of the service attributes demanded by most enterprises and which can be provided via wireline DS1 circuits. As the Commission explained: "bandwidth, security, and other technical limitations on cable modem service render it an imperfect substitute for service provided over DS1 loops." *Id.* ¶ 193. It is therefore not surprising then that the RBOCs could provide "little evidence . . . that cable companies are a significant presence in the enterprise loop market." *Id.* The Commission

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<sup>28</sup> *Pricing Flexibility Order* ¶ 144 ("[i]f an incumbent LEC charges an unreasonably high rate for access to an area that lacks a competitive alternative, that rule will induce competitive entry, and that entry will in turn drive down rates.")

<sup>29</sup> *See Zimmerman* at 127 ("Market Power is the ability of a LEC to sustain prices above the competitive level for an extended period of time without significant loss in customers. Market power can be inferred when a firm is able to implement a price increase absent a significant increase in costs or quality. *This sort of evidence is especially indicative when the prices that are high and rising relative to economic costs fail to attract new competitors or when entry into the market remains essentially foreclosed.*") (emphasis added).

<sup>30</sup> TWTC's 2004 annual report stated that it added 900 buildings to its network that year. *See Time Warner Telecommunications Inc. 2004 Annual Report* at 3 ("*TWTC 10-K*"). In the first 3 months of 2005, TWTC added 207 buildings to its network. *See TWTC 10-Q* at 21; *TWTC 10-K* at 30.

similarly concluded that fixed wireless services do not constitute a viable substitute for high capacity wireline loops.<sup>31</sup>

### III. **THE ILECS HAVE EXERCISED MARKET POWER IN AREAS IN WHICH THEY HAVE BEEN GRANTED PRICING FLEXIBILITY AND THEIR OPPORTUNITIES TO ENGAGE IN THIS CONDUCT ARE INCREASING**

Because of their enduring market power, the ILECs have taken advantage of premature grants of pricing flexibility in over 150 markets to raise rates.<sup>32</sup> Rates have increased in Phase II areas both on month-to-month tariffs as well as on standard tariffed long-term commitment plans.

The increase in special access rates under pricing flexibility has been studied and documented in excruciating detail. Most notably, in 2004, FCC economists Paul R. Zimmerman and Noel Uri conducted an extensive study which demonstrated that ILECs continue to exercise market power over special access services in those areas where they have been granted pricing flexibility. Indeed, the ILECs' rate of return in the pricing flexibility markets well exceeds what would be expected in a competitive marketplace. Zimmerman and Uri note that, while special access provided only a 7.4% rate of return to the ILECs in 1996, this had climbed to 37.1% in 2003. *See id.* at 126. Moreover, ILEC special access revenues nearly quadrupled from \$3.1 billion in 1996 to \$ 12 billion in 2002. *See id.* Over this same time period, special access lines grew as a percentage of all access lines from 8.9 percent to 41 percent. *See id.* As Messrs

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<sup>31</sup> *See TRRO* n.508 (“The record does not indicate that other intermodal options, such as fixed wireless and satellite, offer significant competition in the enterprise loop market.”).

<sup>32</sup> Zimmerman notes that, as of 2004, ILEC pricing flexibility for channel terminations had been granted for more than 158 MSAs while more than 186 MSAs had been granted pricing flexibility for transport (channel mileage). *See Zimmerman* at 125.

Zimmerman and Uri note, it runs counter to economic theory that prices would continue to rise as output increases in a market (such as special access) characterized by substantial economies of scale and scope.<sup>33</sup> The only reasonable inference is that the special access market is not competitive. *See id.*

By scrutinizing DS1 and DS3<sup>34</sup> channel mileage and termination rates (not merely rates of return), Zimmerman and Uri were able to determine that rates under pricing flexibility increased substantially for almost every BOC, in almost every pricing flexibility market for both month-to-month offerings as well as for rates subject to long term commitments. *Id.* at 156-7. They concluded that “LECs subject to price caps who have been granted pricing flexibility have taken advantage of the opportunity...To a greater or lesser degree, depending on the individual LEC, rates have been raised by LECs in an environment where these LECs are already earning rates of return substantially in excess of what they would earn in a competitive market.” *Id.* at 157. This pattern stands in marked contrast to prices for long haul transmission services. Those services share many of the basic technical characteristics of local transmission. But, on long-

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<sup>33</sup> *See id.* ¶ 157 (“In a competitive market where demand for special access service is growing, as characterized by the growth in special access revenue, this should result in the rates actually falling. The fact that no rates have declined and that many have increased is further evidence that the price cap LECs are exercising market power and that the market for special access service is not competitive.”).

<sup>34</sup> There does not appear to be any analysis in the record or elsewhere of the prices or rates-of-return for Ethernet services provided over high capacity loops. These services, like DS3 and DS1 channel terminations, are currently subject to the pricing flexibility regime. *See e.g., Ameritech Operating Companies Petition for Pricing Flexibility for Dedicated Transport and Special Access Services; Southern New England Telephone Company Petition for Pricing Flexibility for Dedicated Transport and Special Access Services; Southwestern Bell Telephone Company Petition for Pricing Flexibility for Dedicated Transport and Special Access Services*, Order, DA 05-1525 (rel. May 25, 2005). As explained in section IV *infra*, where the revenue opportunities for Ethernet are similar to those associated with DS3 services, the Ethernet services should be subject to price caps.

haul transmission routes where competition is ubiquitous, prices have fallen more than 90 percent since 1999.<sup>35</sup>

Substantial evidence has already been placed on the record in this proceeding that rates have nearly universally increased under pricing flexibility. For example, even SBC's tariffed long term, 5 year rates for channel terminations in the "most competitive" zone 1 are more than 11% higher in areas where it has been granted pricing flexibility.<sup>36</sup> PacBell's 36 month 10 mile DS3 price cap rate has dropped over 15% since July 2001, while the rates in pricing flexibility areas have remained the same. *See Global Crossing ex parte* at 15. Similarly, while a Verizon 10 mile month-to-month DS1 circuit cost approximately \$675 in 2001, that same circuit under price caps is now approximately \$610 but under pricing flexibility, nearly \$800. *See id.* at 16.

The ILECs have tried to argue that these supra-competitive tariff rates are irrelevant to any calculus of their market power since few carriers actually pay the tariff rate. Rather, they allege that carriers and large customers purchase special access at reasonable rates by entering into volume and term discount plans permitted by pricing flexibility. However, the pricing and structure of these discount plans nevertheless demonstrate the ILECs' continuing market power and attendant ability to unilaterally raise prices.<sup>37</sup> As discussed in section IV *infra*, only the

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<sup>35</sup> *See Global Crossing Opposition* at 16, n.35; *Wilkie Declaration* ¶ 10 ("Consider the market for DS3 level transport from New York to Los Angeles, a distance of approximately 2,500 miles. In June 1999, such a circuit would be leased for \$55,000 per month. In February 2004, the price was \$3,500 per month. This represents a decline of over 90 percent.").

<sup>36</sup> *See Reply Declaration of Michael Pelcovitz and Chris Frentrup* ¶ 19 attached to Letter of Thomas Cohen, Principal, KDW Group to Marlene H. Dortch, Secretary, FCC, WC Dkt. Nos. 04-313 *et al.*, (filed Oct. 19, 2004).

<sup>37</sup> As is discussed in more detail below, many of the anticompetitive aspects of the ILECs' volume and term discount plans can be mitigated if carriers are able to continue to purchase special access circuits under price caps.

availability of a price cap rate as a “backstop” will ameliorate some of the BOC’s incentives and ability to abuse their market power through these contracts.

Without regulated price cap rates as a backstop, the problems with volume and term discount contracts are numerous. For example, the ILECs generally offer volume and term discounts on their underlying month-to-month or 60 month basic tariff rates, but then may unilaterally increase the price in these basic rates where they have received Phase II pricing flexibility and are no longer subject to price caps. As the tariffed rates increase, so too do the long term contract rates to which the monthly tariffs are tied.

Qwest’s 2004 increase of its month-to-month DS1 rates is a prime example of this dynamic.<sup>38</sup> TWTC purchases special access from Qwest under Qwest’s “Regional Commitment Plan” (“RCP”) under which TWTC receives a 20 percent discount off of month-to-month rates for DS1 and DS3 channel terminations so long as TWTC meets the defined commitment level of circuits in each of the four years of the agreement. Since TWTC’s discount is pegged to the tariffed month-to-month rates; an increase in these rates leads to higher contract rates for TWTC. This is what occurred when Qwest increased these rates last year. As a result of the increases, TWTC’s prices for special access in Qwest’s region have risen by approximately 19 percent. The increases were greatest for DS1 facilities which are the least likely to face competitive supply because they offer the smallest revenue opportunities among special access services demanded by business customers. For example, TWTC faced rate increases of nearly 25% for

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<sup>38</sup> See Revisions by Qwest Corporation to Tariff FCC No. 1, Transmittal No. 206. TWTC had previously opposed the Qwest tariff as not just and unreasonable under section 201(b). See Petition of Time Warner Telecom to Reject, or Alternatively, Suspend and Investigate, Revisions by Qwest Corporation to Tariff F.C.C. No 1, Transmittal No. 206 (filed Aug. 23, 2004).

rates applicable to DS1 channel terminations in “the most competitive” zone 1 as well as for rates applicable to 0-8 mile mileage DS1 transport.

Despite the current highly concentrated state of the special access marketplace, the incentives and opportunities for ILECs to exercise their market power are only increasing. For example, the FCC has eliminated unbundling for packet-switched loops (e.g., Ethernet) and reduced the availability of DS1 loops. It has done so even in areas where CLECs cannot efficiently deploy those facilities. As the Commission notes, “competitive deployment of stand-alone DS1-capacity loops is rarely if ever economic” *TRRO* ¶ 166

If the proposed Bell-IXC mergers are consummated, the RBOCs’ monopoly over special access services would only become more entrenched. Following the merger, AT&T and MCI would be eliminated as competitive wholesalers of special access in the SBC and Verizon regions respectively. As many commenters note, because of the relatively large scope of AT&T and MCI’s networks, they serve as a primary check on ILEC special access pricing. This is so because of the comparatively large number of buildings to which they have deployed competitive fiber<sup>39</sup> and their unique special access discounts<sup>40</sup> which they are apparently able to obtain and pass on to carrier customers. For example, BellSouth’s contract tariffs have provided

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<sup>39</sup> See *Broadwing Opposition* at 23 (“AT&T and MCI are the BOC’s primary, and in many cases, only competitors. Although special access facilities that AT&T and MCI own reach only a fraction of the buildings served by the BOCs, they reach many more buildings than any other company and normally reach the larger buildings in the area.”). In response to an RFP from Broadwing, only “AT&T provided a substantial list of buildings that it reached with its own network facilities--although its list was far shorter than the total number of buildings served by Verizon.” *Id.* at 26. Global Crossing notes that “suburban and ex-urban office locations are only served by AT&T, MCI and the RBOCs.” *Global Crossing ex parte* at 6.

<sup>40</sup> See *id.* at 15 (“...because of...the huge volume of special access services that AT&T purchases, AT&T has buying power that no other competitor can match....When AT&T resells SBC special access services, AT&T passes on some of its discount to its wholesale customers, and provides service at rates lower than offered by SBC.”); *Cbeyond Opposition* at 24; Opposition of CompTel/ALTS, WC Dkt. No. 05-65 at 14 (filed Apr. 25, 2005) (“*CompTel/ALTS Opposition*”).

the largest discounts for carriers with over \$600 million in special access purchases.<sup>41</sup> MCI and AT&T are probably the only customers that would be able to qualify for these discounts.<sup>42</sup> The RBOCs have clear incentives to provide these discounts to the largest carriers such as AT&T and MCI because, absent these deep discounts, these carriers might be induced to further expand their networks. *See Comptel/ALTS Opposition* at 14.

A review of the competitive situation in Milwaukee demonstrates both that the current pricing flexibility triggers have little bearing on competitive deployment and that the removal of AT&T and MCI will only make matters worse. Milwaukee has been granted Phase II pricing flexibility,<sup>43</sup> yet the removal of just AT&T from the Milwaukee market results in a 64 percent decline in CLEC served buildings in that market. *See Wilkie Declaration* at 9. Overall, Professor Wilkie estimates that the removal of AT&T alone will result in wholesale rate increases of 100 percent in most markets. *See id.* at 12. Since DS1 circuit costs account for approximately one third of CLECs' incremental costs, such a price squeeze will likely push many carrier customers out of the marketplace since they would be unable to compete at the retail level against the RBOC's own offerings. *See id.*

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<sup>41</sup> *See AT&T Corporation v. BellSouth Telecommunications Inc.*, File No. EB-04-MD-010, Memorandum Opinion and Order, 19 FCC Rcd 23898, ¶ 24 (2004). BellSouth's tariff was struck down on the grounds that it favored its own long distance affiliate (*see id.*) but there is no reason to think that BellSouth or any other RBOC would not retain the same or similar revenue tiers that were set forth in BellSouth's tariff.

<sup>42</sup> *Comptel/ALTS Opposition* at 18 (noting that it is likely that, post merger, there will be few firms spending more than \$300 million in special access revenues for any one RBOC). Indeed, as *Comptel/ALTS* notes, other than MCI and AT&T there are only a handful other carriers with more than \$300 in revenues. *See id.* at 45.

<sup>43</sup> *See Petitions for Pricing Flexibility for Special Access and Dedicated Transport Services for Ameritech Operating Companies, Pacific Bell Telephone Company, Southern New England Telephone Company and Southwestern Bell Telephone Company*, Memorandum Opinion and Order, 17 FCC Rcd 6462 (2002) (granting Phase II relief for channel terminations in Milwaukee).

**IV. THE COMMISSION MUST IMMEDIATELY ELIMINATE PHASE II PRICING FLEXIBILITY FOR DS1, DS3 AND ETHERNET SERVICES AND IT MUST REASSESS ITS RULES IN LIGHT OF APPROPRIATE MARKET DEFINITIONS AND STANDARDS FOR IDENTIFYING COMPETITIVE MARKETS**

As is apparent from the foregoing discussion, the most obvious and serious flaw in the current special access regulatory regime is the absence of a “backstop” regulated rate for services for which the incumbent LECs have market power. In a competitive market, the incumbents would not be able simply to raise the underlying rates to which volume/term discounts apply at will. Yet, as explained, this is exactly what the incumbents have done and will likely continue to do in the future.

At the same time, TWTC and numerous other parties have entered into volume and term agreements for special access. To be sure, TWTC wants to avoid increases in the underlying tariffed (but not price cap regulated) rates to which the discounts in these agreements apply. Nevertheless, TWTC has entered into its volume-term agreements based on the expectation that they will remain stable commercial arrangements and that TWTC can plan its business accordingly. It would be affirmatively harmful for the Commission to, for example, render null and void volume-term agreements regardless of whether the purchasing party wishes to continue to operate under the agreement.

The Commission should promptly adopt interim changes to its existing pricing flexibility rules that balance these concerns and that remain in place while the Commission undertakes a more thorough review of the existing regulatory regime. Specifically, the Commission should limit the incumbents’ ability to raise tariffed prices unilaterally by eliminating Phase II pricing flexibility for services over which the incumbents have substantial and continuing market power. Most obviously, Phase II pricing flexibility should be eliminated for services for which the

incumbents have unilaterally increased prices or kept prices steady in the face of substantial decreases in average costs. As explained, the record demonstrates that this is the case at least with regard to DS1 and DS3 mileage and channel termination charges.

Moreover, the Commission should also eliminate Phase II pricing flexibility for special access services with characteristics similar to DS1 and DS3 service. The Commission has held that local transmission services generally cost the same to deploy regardless of the bandwidth delivered by the service. *See TRRO* ¶ 149. The Commission has also held that the key variable for determining whether a competitor can efficiently deploy facilities to provide a service is the revenue opportunity (i.e., the price level) associated with the service. *See TRRO* ¶ 149; *TRO* ¶ 100. Thus, it can be assumed that incumbent LECs have roughly the same ability to unilaterally raise prices for all special access channel termination services for which the prices charged similar and for all transport services for which the prices charged are similar.

For example, the incumbents charge similar prices for DS3 service and Ethernet service. BellSouth's month-to-month rate for their LightGate 2 DS3 service is \$3,680,<sup>44</sup> while its month-to-month rate for 1 Gbps Metro Ethernet service is \$2,850.<sup>45</sup> Similarly, SWBT's 12 month (SBC) rate for 2 DS3s is \$3,900 in Texas<sup>46</sup> while the 12 month rate for its Gigabit Ethernet Metropolitan Area Network product is \$3,300.<sup>47</sup> It is generally inefficient for carriers to incur the sunk costs of loop construction solely for purposes of providing 2 DS3s (or less) of

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<sup>44</sup> *See* BellSouth, Tariff FCC No 1. § 7.5.9(A)(3)(a).

<sup>45</sup> *See id.* § 23.5.2.23(A)(1)(c).

<sup>46</sup> *See* Southwestern Bell Telephone Company, Tariff FCC No. 73, § 20.5.2(M).

<sup>47</sup> *See id.* § 7.3.12(M)(1)(a).

capacity.<sup>48</sup> It follows that carriers would be unable to deploy loops for the purpose of providing Ethernet services for which the revenue opportunities are actually slightly lower. Accordingly, the Commission should eliminate Phase II pricing flexibility for such Ethernet services.

By eliminating Phase II pricing flexibility and retaining Phase I pricing flexibility in areas in which it has already been granted, the Commission would effectively limit further rate increases while allowing companies that have entered into volume/term agreements to continue operating under those agreements if they would like to do so. This strikes the proper balance between addressing the most obvious opportunities for incumbents to abuse their market power while not disrupting unnecessarily existing commercial agreements.

It is important to point out, however, that the Commission must give customers the right, if they so choose, to discontinue purchasing any service for which Phase II pricing flexibility is eliminated pursuant to an existing agreement without incurring termination penalties. This type of “fresh look” is appropriate where regulation yields lower prices for a service over which the incumbent has market power. For example, when the Commission adopted TELRIC-based pricing for services subject to interconnection agreements that preceded the adoption of the 1996 Act, the Commission granted CMRS carriers a “fresh look” right to enter into agreements that took advantage of the newly-prescribed, lower rates.<sup>49</sup> Similarly, here, it would be appropriate to

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<sup>48</sup> See *ex parte* presentation of MiCRA *et al.*, WC Dkt. Nos. 04-313 *et al.*, at 5 (filed Oct. 18, 2004) (citing CLEC filings for the proposition that “KMC will not build laterals unless a customer purchases at least 3 DS3s...XO will not construct laterals unless combined customer demand in a building reaches at least 3 DS3s...Xpedius requires a bare minimum of 3 DS3s in customer demand before constructing laterals...For buildings over 500 feet from its fiber ring, ATI requires that a customer order OC-3 service before building...Echelon and SNIPLink report that it is never economic to self deploy loops to their bases of DS1 service customers.”) (internal citations omitted).

<sup>49</sup> See *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996 et al.*, First Report and Order, 11 FCC Rcd 15499, ¶ 1095 (1996).

allow customers to enter into new service arrangements that take advantage opportunities created by changes in regulation designed to limit the abuse of market power.

Eliminating Phase II pricing flexibility of course requires the reapplication of price caps to the services in question. The Commission should accomplish this by seeking to ensure that prices for reregulated services are set at levels that would have applied had they never been removed from price caps. It is difficult to achieve this outcome because incumbents have the flexibility to increase and decrease prices within the special access basket so long as the overall weighted average of the prices of services in the basket do not exceed the relevant price cap index. That is, the prices that would have been in effect had price caps applied all along would not just have been the result of implementing regulatory formulas, but rather would have been influenced by the business judgment of the incumbent LEC. The Commission should therefore seek to set the prices for reregulated services at levels that, to the extent possible, reflect such business judgments.

There may be several ways to approximate this outcome. For example, the Commission could begin by determining the percentage change in prices charged by an incumbent LEC for a particular service, e.g., DS3 channel terminations, offered outside of the geographic areas in which Phase II pricing flexibility has been granted during the period that service has been free of price caps in Phase II areas. The Commission could then take the price charged for the service in a Phase II area before the service was freed from price caps and then adjust it by the percentage change in the prices for the same service outside of the Phase II areas during the relevant period. In this manner, the Commission could roughly replicate the changes in prices that would have occurred had the service in question never been exempted from price caps in the Phase II areas.

While this interim measure is a critically important first step in reform, the Commission must also comprehensively reassess its broader regulatory framework for special access. Such an undertaking is complex and, as the Commission indicates in the NPRM, requires a thorough review of the appropriate product and geographic markets as well as the appropriate means of measuring competition. While TWTC does not propose specific reform measures at this time, it is important to emphasize that any framework for regulating special access must account for the differences in revenue opportunities between different capacities and types of service. Moreover, any regulatory framework for special access channel terminations must reflect the fact that carriers decide to construct loop facilities to commercial customers based on the characteristic of particular buildings. The characteristics of a broader geographic areas (e.g., wire centers) are relevant to whether a competitor decides to construct transport facilities, but they have little relevance to whether a competitor can justify building loops. If the Commission seeks to adopt new criteria for pricing flexibility (i.e., Phase II flexibility), it must use measures for competitive entry that, unlike collocation, are reliable indicators of actual (not potential) competition. For example, a traditional non-dominance analysis may well be appropriate for special access products and geographic markets with similar characteristics.

## V. CONCLUSION

The Commission should modify the existing regulations governing special access pricing flexibility

