

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

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

REPLY COMMENTS OF QWEST COMMUNICATIONS INTERNATIONAL INC.

Blair A. Rosenthal
Craig J. Brown
Michael B. Adams, Jr.
Suite 950
607 14th Street, N.W.
Washington, DC 20005
(303) 383-6649

Attorneys for
QWEST COMMUNICATIONS
INTERNATIONAL INC.

July 29, 2005

TABLE OF CONTENTS

	<u>Page</u>
I. INTRODUCTION AND SUMMARY	1
II. THE COMMISSION’S ACTIONS IN THIS PROCEEDING ULTIMATELY SHOULD TURN ON WHETHER COMPETITIVE CONDITIONS ARE SUFFICIENT TO CONSTRAIN SPECIAL ACCESS PRICES	4
A. The Commission Cannot Accurately Evaluate Competitive Conditions In The SBC And Verizon Regions Until It Completes Its Review Of The Proposed SBC-AT&T And Verizon-MCI Mergers	5
B. The ARMIS Data Relied On By The CLECs And Others Are Meaningless And Fail To Provide A Reasonable Basis For The Commission To Revise Its Pricing Flexibility Or Price Cap Rules	6
C. The Price Increases Alleged By The CLECs Do Not Demonstrate The Existence Of Market Power	9
D. The Commission Lacks A Sufficient Record To Adopt Any Interim Relief	10
III. THE COMMISSION SHOULD NOT ADOPT AN X-FACTOR THAT IS SPECIFIC TO SPECIAL ACCESS SERVICES	11
IV. THE COMMISSION SHOULD NOT RE-INITIALIZE RATES BASED ON TELRIC OR ANY OTHER ABSTRACT COSTING MECHANISM	13
V. THE COMMISSION SHOULD NOT REINSTITUTE REVENUE SHARING	16
VI. THE COMMISSION SHOULD NOT LIMIT THE LOW-END ADJUSTMENT	18
VII. CONCLUSION	20

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

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

REPLY COMMENTS OF QWEST COMMUNICATIONS INTERNATIONAL INC.

Qwest Communications International Inc. (“Qwest”) respectfully submits these Reply Comments to the Notice of Proposed Rulemaking in the above-captioned proceeding.¹

I. **INTRODUCTION AND SUMMARY**

Ultimately, the Federal Communications Commission (“Commission”) must assess in this proceeding whether competitive conditions in particular special access markets are sufficient to constrain special access pricing as the Commission intended. As Qwest noted in its initial comments, however, the Commission cannot make an informed determination on this issue until it has completed the pending merger dockets. For at least two price cap local exchange carriers (“LECs”), the outcome of the merger dockets will have a profound effect on the state of competition in their special access markets. Consequently, the Commission should finish its review of the mergers before addressing the issues in this proceeding. That includes

¹ *In the Matter of 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, WC Docket No. 05-25, RM-10593, 20 FCC Rcd 1994, 2041 ¶ 147 (2005) (“Notice”).

consideration of any of the expansive interim measures sought by the competitive local exchange carriers (“CLECs”).²

In the record compiled so far, the CLECs continue to base their pleas for Commission intervention almost exclusively on ARMIS rate-of-return data and purported price increases by the incumbent LECs. While such data may have a superficial appeal because they are quantifiable, they provide no meaningful insight into the question of whether competitive conditions are sufficient to constrain special access rates in Phase II metropolitan statistical areas (“MSAs”), and whether price cap rates should be reduced through the adoption of an X-factor. ARMIS rates of return for particular categories of services are simply devoid of any significance, given the arbitrary cost allocations inherent in that data and the Commission’s freeze of the separations allocators. For the most part, the CLECs simply ignore these problems and once again repeat the same meaningless rate-of-return figures. To the extent they attempt to defend the ARMIS data, the CLECs fall far short.

The CLECs also ignore the flaws in their claims that alleged price increases by price cap LECs constitute an exercise of market power. The fact that some special access rates may have increased does not demonstrate that those rates are supracompetitive, particularly given that those rates were kept below market levels through regulation.

Contrary to the arguments by Ad Hoc and several other parties, the Commission should not adopt an X-factor that is specific to special access services. It is not possible to accurately measure productivity for individual categories of services such as special access, just as it is not possible to accurately segregate the individual cost of an individual service provided by a carrier.

² For the sake of convenience, Qwest refers to the proponents of regulatory-imposed reductions in special access rates as “CLECs,” even though some of those commenters, such as the Ad Hoc Committee, are not actually CLECs.

It is also clear that the Commission should not re-initialize special access rates based upon Total Element Long Run Incremental Cost (“TELRIC”) or any other abstract costing mechanism.

There is no legal or factual justification for such action, particularly given that the ARMIS data cited by the proponents of re-initialization are flawed and unrepresentative of actual returns. Re-initialization would amount to a sweeping policy reversal by the Commission and would throw the industry into turmoil. And even if re-initialization was justified, basing special access rates on theoretical methodologies such as TELRIC would not be appropriate, would cause a significant decline in earnings, devalue existing incumbent LEC and CLEC investments, and reduce incentives for future investment.

The Commission should not reinstitute sharing requirements. Sharing is a thoroughly discredited regulatory mechanism that the Commission discarded for good reason. The proponents of reinstating an earnings sharing system offer few policy rationales for re-adopting the policy, other than pushing forward arguments that the Commission has already rejected.

If the Commission adopts a new price cap plan for special access services, the Commission should, at a minimum, retain a low-end adjustment for LECs that have not opted into pricing flexibility and that earn less than a minimum rate of return. If the Commission changes the current price cap and pricing flexibility rules, however, it should go further and extend the low-end adjustment to all price cap LECs whose earnings drop below the Commission’s minimum rate of return, regardless of whether or not they have obtained pricing flexibility.

II. THE COMMISSION’S ACTIONS IN THIS PROCEEDING ULTIMATELY SHOULD TURN ON WHETHER COMPETITIVE CONDITIONS ARE SUFFICIENT TO CONSTRAIN SPECIAL ACCESS PRICES

The CLECs generally focus on two types of “evidence” that purportedly demonstrate that special access rates are excessive and must be reduced through increased regulation, particularly through the elimination of pricing flexibility. First, the CLECs rely on sharp increases in the ARMIS-based accounting rate of return for special access services over the past few years. Second, the CLECs claim that alleged price increases for special access services constitute an exercise of market power by price cap LECs. As explained below, neither of these data sources provide meaningful insight into the appropriate type of regulation for special access services in a particular market. As the record reflects, the ARMIS rates of return cited by the CLECs are meaningless, both in terms of their absolute values and their relative changes from year to year. The purported increases in special access prices pointed to by the CLECs should be given little weight in the Commission’s deliberations. It generally is unclear whether the rates actually paid by special access customers have increased. Moreover, even if some special access rates have increased, it does not follow that the resulting rates are supracompetitive. Given that these services had been subject to more than a decade of regulatory-imposed reductions (including four years of non-productivity-based reductions under the Coalition for Affordable Local and Long Distance Service Plan³), the resulting rates likely bear no resemblance to the rates that would prevail in a competitive market. Furthermore, the Commission fully expected that some special access rates would increase.

³ See *In the Matter of Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Low-Volume Long-Distance Users; Federal-State Joint Board on Universal Service*, Sixth Report and Order in CC Docket Nos. 96-262 and 94-1, Report and Order in CC Docket No. 99-249, Eleventh Report and Order in CC Docket No. 96-45, 15 FCC Rcd 12962 (2000) (“CALLS Plan” or “CALLS Order”).

Instead of focusing on these diversions, the Commission ultimately must consider whether competitive conditions in Phase II MSAs are sufficient to constrain special access rates below supracompetitive levels, as the Commission expected in the *Pricing Flexibility Order*. At least for Verizon and SBC, the Commission cannot make that determination until it has completed its consideration of those companies' pending mergers.

A. The Commission Cannot Accurately Evaluate Competitive Conditions In The SBC And Verizon Regions Until It Completes Its Review Of The Proposed SBC-AT&T And Verizon-MCI Mergers

As acknowledged by various commenters, the proposed mergers will have a substantial affect on the issues raised in the *Notice*.⁴ In the SBC and Verizon regions, the mergers will eliminate the two largest providers of competitive alternatives to the incumbent LECs' special access services. For this reason, Qwest and other CLECs have urged the Commission to reject the proposed mergers, or at least to adopt significant conditions to ameliorate the harmful effects of the mergers. As Qwest explained in its opening comments, until the Commission completes its consideration of the potential mergers, and determines the outcome of that review, it cannot accurately assess the state of competition in special access markets in the SBC and Verizon regions. The Commission's analysis of competition in those regions will depend heavily on whether the Commission allows the mergers to go forward, and, assuming it does, the conditions that will apply to its approval of the mergers. The Commission therefore should defer making definitive decisions in this proceeding of general applicability until it has concluded its review of the proposed mergers.

⁴ See, e.g., API Comments at 2-4; Time Warner Comments at 10-12.

B. The ARMIS Data Relied On By The CLECs And Others Are Meaningless And Fail To Provide A Reasonable Basis For The Commission To Revise Its Pricing Flexibility Or Price Cap Rules

As in the past, the CLECs rely heavily on the ARMIS rates of return for special access services. Qwest and others have previously explained in detail the numerous pitfalls of drawing any conclusions from special access rates of return. In short, rates of return for individual services based on fully distributed costs are meaningless, because such computations rely on arbitrary allocations of common costs.⁵ Moreover, the accounting and jurisdictional separations rules underlying the rate-of-return figures have failed to keep up with the introduction of new services over the past decade. In one particularly blatant example, the separations rules assign the revenues for Digital Subscriber Line (“DSL”) services to the interstate jurisdiction, but only a portion of the cost.⁶ The Commission’s freeze of separations allocators in the *Separations Freeze Order* only exacerbated these problems.⁷ In the case of DSL, the separations freeze resulted in digital subscriber line access multiplexer (“DSLAM”) investment being allocated between the interstate and intrastate jurisdictions, rather than being directly assigned to the interstate jurisdiction.⁸ Such misallocations of cost to the intrastate jurisdiction plainly inflate the accounting rate of return for particular interstate services.

The CLECs generally do not even attempt to defend their use of the ARMIS figures.

However, Ad Hoc raises a number of feeble justifications for relying on the ARMIS data, such as

⁵ See Declaration of Alfred E. Kahn and William E. Taylor on Behalf of BellSouth Corporation, Qwest Corporation, SBC Communications, Inc., and Verizon, attached to Opposition of Qwest Communications International Inc. at 7 (filed Dec. 2, 2002).

⁶ See Fitzsimmons Reply Declaration (attached hereto) at 4-5; Fitzsimmons Initial Declaration at 2-3.

⁷ Fitzsimmons Reply Declaration at 4-5.

⁸ Fitzsimmons Initial Declaration at 2-3.

the fact that the ARMIS accounting rules were developed over several decades.⁹ As noted by Dr. Fitzsimmons, however, those accounting rules were never designed to provide an accurate estimate of rates of return for specific categories of service, such as interstate special access.¹⁰ The cost allocations inherent in ARMIS were designed to serve specific regulatory goals that did not require meaningful cost-causative assignments of cost to particular services. Moreover, substantial amounts of costs were allocated for reasons other than cost causation.¹¹ The fact that the incumbent LECs played a large role in generating ARMIS data to be used for other purposes is irrelevant to the question of whether such data are meaningful in this context. Clearly they are not.

Ad Hoc erroneously suggests that the numerous misallocations in ARMIS do not affect the overall integrity of *trends* in the ARMIS data, because the misallocations do not change from period to period.¹² This is simply wrong. As Dr. Fitzsimmons demonstrates, growth in demand for particular services can greatly magnify the impact of a cost misallocation from year to year.¹³ Dr. Fitzsimmons provides an illustrative example in which the impact of the same cost misallocation (or set of misallocations) grows from about five percent to more than 50 percent over several years.¹⁴ Qwest has seen substantial growth in DSL and other packet-based services for which there clearly is a cost misallocation in the ARMIS rules. Between 2000 and 2003,

⁹ See Ad Hoc Comments at 29.

¹⁰ Fitzsimmons Reply Declaration at 3.

¹¹ *Id.*

¹² See Ad Hoc Comments at 29. See also Notice, 20 FCC Rcd at 2006 ¶ 29 (“To the extent the accounting rules have remained the same over the period analyzed, the analysis of growth rates and scale economies should not be significantly affected by the cost allocation issues these parties raise.”).

¹³ Fitzsimmons Reply Declaration at 6-8.

¹⁴ *Id.*

Qwest's DSL customers increased from 255,000 to 637,000. Qwest now has more than a million DSL customers. As a result of this growth, the magnitude of the cost misallocations for DSL to the intrastate jurisdiction that are inherent in the Part 32 and 36 rules have increased each year, which in turn has bumped up the accounting rates of return for interstate special access services. The impact of the DSL misallocation issue therefore is much more pronounced today than it was in 2000 or 2001. The same is true of other misallocations that apply to services that have seen increases (or decreases) in demand over the past several years.

Ad Hoc also ignores the impact of the separations freeze adopted in the 2001. The freeze caused the accounting rate of return for interstate special access services to increase substantially since that time.¹⁵ The frozen allocator essentially assumes that interstate and intrastate special access revenues are increasing at the same rate. Between 2000 and 2003, that was far from true. In 2000, 80 percent of Qwest's special access revenues were interstate. Just three years later, that figure had risen to 86 percent. The result of the freeze is that a growing amount of costs that should be associated with interstate special access services are being assigned to the intrastate jurisdiction, thereby inflating the accounting rate of return for special access services. Thus, contrary to the assumptions in the *Notice*, the accounting rules have changed dramatically during the relevant period.¹⁶

Dr. Fitzsimmons also identifies a substantial variance in the purported interstate special access rates of return for the four Bell Operating Companies ("BOCs"). Often such a wide variance in results indicates a flaw in the data, unless there is a reasonable explanation for that variance. Here there is none. The variance is almost surely due to the fact that the data are not

¹⁵ Fitzsimmons Reply Declaration at 4-5.

¹⁶ As SBC notes, the fact that the trends in ARMIS rates of return changed immediately and dramatically after the institution of the freeze strongly suggests that the change was an artificial byproduct of the freeze. SBC Comments at 31-32.

suitable for estimating meaningful rates of return for special access services.¹⁷ Furthermore, the miniscule implied rates of return for interstate services other than special access suggest that the ARMIS data cannot be used to generate meaningful rates of return for specific services or categories of services.¹⁸

In short, even relative changes in the ARMIS rate-of-return figures from year to year for special access services have no significance. The Commission should place no reliance on these figures in determining the appropriate regulation of special access services going forward.

C. The Price Increases Alleged By The CLECs Do Not Demonstrate The Existence Of Market Power

The purported increases in Qwest's special access rates claimed by certain commenters also do not suggest that those rates are at supracompetitive levels. It is more likely that the price cap rates are too low, given the application of sizable X-factors for the past 15 years, including four years of rate reductions under the CALLS Plan without any productivity analysis.¹⁹ The transition from regulated prices to competitive prices is almost certainly generating prices that are more rationally related to costs, with lower prices for some customers and higher prices for others. This is necessarily true if average prices were set at reasonable levels in the more tightly regulated environment, and it is consistent with the Commission's expectations in the *Pricing Flexibility Order*.²⁰

For the most part, the CLECs focus on changes in month-to-month rates that most special access customers do not pay. Because of pricing flexibility, Qwest has been able to customize

¹⁷ Fitzsimmons Reply Declaration at 6-9.

¹⁸ *Id.* at 9.

¹⁹ Fitzsimmons Reply Declaration at 10-11.

²⁰ See *In the Matter of Access Charge Reform, Fifth Report and Order and Further Notice of Proposed Rulemaking*, 14 FCC Rcd 14221, 14301-02 ¶ 155 (1999) ("*Pricing Flexibility Order*").

tariffs to the needs and cost characteristics of customers. Through the functioning of competitive markets, these tariffs lower effective prices for all special access customers, including non-incumbent LEC customers and smaller incumbent LEC customers who have the option of switching to large service aggregators.

D. The Commission Lacks A Sufficient Record To Adopt Any Interim Relief

As Qwest has previously shown, there is no foundation for increasing the X-factor, whether on a permanent or interim basis.²¹ The Commission should also reject the far-reaching “interim” measures sought by other commenters, such as reducing special access rates in pricing-flexibility MSAs to price cap levels.²² Such action is simply too significant for the Commission to undertake in a hasty manner.

Moreover, for the reasons discussed above, the Commission should not take any action in this docket until it has completed its review of the proposed SBC-AT&T and Verizon-MCI mergers. Given the long-term implications of the issues raised in this proceeding, there is no reason for the Commission to proceed until it has a fully-developed record on all relevant issues, including the outcome of the merger proceedings.

²¹ Qwest Comments at 5-14. *See also* Letter from Craig J. Brown, Qwest, to Marlene H. Dortch, FCC, WC Docket No. 05-25, WCB Pricing 05-22 (filed May 23, 2005) (showing that there was no legal or factual basis to establish an interim X-factor of 5.3%). As Ad Hoc acknowledges, it is highly questionable whether a 5.3% productivity factor would be judicially upheld given the pendency of the remand of the productivity factor adopted by the Commission in the *1997 Price Cap Review Order*. *See* Ad Hoc Comments at 54; *see also In the Matter of Price Cap Performance Review for Local Exchange Carriers*, Fourth Report and Order and Second Report and Order, 12 FCC Rcd 16642, 16648-49 ¶¶ 8-11, 16697 ¶ 141 (1997).

²² *See* Ad Hoc Comments at 52-54; CompTel Comments at 35-36; *see also* ATX Comments at 16.

III. THE COMMISSION SHOULD NOT ADOPT AN X-FACTOR THAT IS SPECIFIC TO SPECIAL ACCESS SERVICES

Several parties argue that the Commission should adopt a new X-factor that is specific to special access services.²³ Qwest strongly disagrees.

From a practical economic standpoint, it is simply not possible for the Commission to measure productivity for a particular group of services, let alone a specific, isolated service such as special access.²⁴ Verizon is correct that special access services are not produced on a stand-alone basis: they use the same network facilities and personnel as a carrier's other telecommunications services.²⁵ Because of the extensive common costs that characterize the telecommunications industry, the Commission would simply be unable to accurately compute an accurate productivity factor for special access services in isolation.²⁶

For the same reasons, there is also no policy reason for distinguishing special access from the productivity realized for an incumbent LEC's switched access services. There is no reason to believe that special access services are subject to productivity gains that are any higher than related switched access services provided by the same incumbent LECs, under the same economic and competitive conditions and often using common facilities.²⁷ As Iowa Telecommunications and Valor Telecommunications of Texas correctly point out in their joint

²³ See Ad Hoc Comments at 44-47; ATX Comments at 24-26; T-Mobile Comments at 6, 19, and 21-22; PAETEC Comments at 17-18.

²⁴ See Fitzsimmons Initial Declaration at 5. As Dr. Fitzsimmons indicated, due to the nature of network economics, productivity studies have concerned the entire network and not the productivity of sub-groups of services. *Id.*

²⁵ See Verizon Comments at 42-43.

²⁶ See, e.g., *USTA v. FCC*, 188 F.3d 521, 528 (D.C. Cir. 1999) (noting that the Commission has never resolved whether it is possible to develop separate productivity measures for interstate and intrastate services).

²⁷ *1997 Price Cap Review Order*, 12 FCC Rcd at 16684-87 ¶¶ 106-10.

comments, this is the reason the Commission has previously declined to adopt service-specific productivity factors, and has instead adopted industry-wide X-factors that measure the productivity of the “LEC industry as a whole.”²⁸

As Qwest established in its initial comments, it is also frivolous to suggest that ARMIS data provides a reasonable means of determining a price cap LEC’s costs of providing special access, much less its rate of return.²⁹ The Commission has never used ARMIS data to examine rates of return for specific service categories to determine whether adjustments were needed to LEC prices.³⁰ This policy has been prudent, based on the acknowledged problems in the accuracy and representativeness of ARMIS data, including its arbitrary cost allocations and the distortions caused by the ongoing separations freeze.³¹ As Dr. Fitzsimmons demonstrates, ARMIS data was generated by price cap LECs for a different regulatory purpose, and is unsuitable for estimating a meaningful rate of return for special access services.³²

Qwest also notes that the *CALLS Order* did not establish that special access services can be segregated from other price cap services on the basis of unusual characteristics or productivity gains. As the Commission is well aware, the *CALLS Plan* was created by industry consensus, and it separated special access from other price cap services only for the explicit purpose of achieving specific, targeted price reductions in special access pricing that were not tied to

²⁸ See Iowa Telecom/Valor Comments at 26-27, citing *Price Cap Performance Review for Local Exchange Carriers*, First Report and Order, 10 FCC Rcd 8961, 9027 ¶ 146 (1995) (noting industry consensus that the X-factor measures productivity across the industry).

²⁹ See Qwest Comments at 5-9, 10-13.

³⁰ See Fitzsimmons Initial Declaration at 2; Fitzsimmons Reply Declaration at 1-9.

³¹ See Fitzsimmons Reply Declaration at 1-9.

³² *Id.*

productivity.³³ The CALLS Plan is therefore completely different from the price cap proposals before the Commission and cannot be borrowed as support for a completely different regulatory mechanism.

IV. THE COMMISSION SHOULD NOT RE-INITIALIZE RATES BASED ON TELRIC OR ANY OTHER ABSTRACT COSTING MECHANISM

Several parties suggest that the Commission should re-initialize the special access rates of price cap LECs at forward-looking levels, based on TELRIC or a similar forward-looking cost methodology.³⁴ Others suggest that the Commission should set the rates for special access services at prices equivalent to those for unbundled network elements (“UNEs”).³⁵ Qwest disagrees with these facile and poorly-supported proposals in the strongest terms, and urges the Commission to be circumspect before considering them.

There is no legal or factual justification for re-initializing special access rates, regardless of which methodology or fixed rate of return is suggested.³⁶ The proponents of re-initialization offer no legitimate evidence demonstrating that the existing price caps have let LECs earn “colossal” or “unlawful” returns on their investments or that pricing flexibility has caused market failure in deregulated markets. Qwest has shown that these claims are demonstrably false.³⁷ The ARMIS data cited by the proponents of re-initialization is plainly flawed and unrepresentative of actual returns, and is not an appropriate basis for ratemaking decisions.³⁸ As Dr. Fitzsimmons

³³ See Notice, 20 FCC Rcd at 2009 ¶ 37.

³⁴ See WilTel Comments at 16-18; BT Americas Comments at 1, 3-7.

³⁵ See ATX Comments at 2, 17-22; T-Mobile Comments at 20-21; PAETEC Comments at 11.

³⁶ Accord, Verizon Comments at 39-41.

³⁷ Qwest Comments at 5-6, 9, 10-12, 15-18.

³⁸ Accord, Iowa Telecom/Valor Comments at 12, citing *Policy and Rules Concerning Rates for Dominant Carriers*, Order on Reconsideration, 6 FCC Rcd 2637, 2730 ¶ 199 (1991) (rates of return based on ARMIS data “do not serve a ratemaking purpose”) (Qwest has adjusted this

demonstrates, ARMIS data therefore does not and cannot provide a rational rate-of-return basis for re-initializing special access rates.³⁹

Furthermore, even if re-initialization were justified based on the record in this proceeding -- and it is not -- basing special access rates on theoretical methodologies such as TELRIC would not be appropriate in the case of special access services. The Commission has not previously based its pricing of special access services on forward looking, long run incremental cost ("LRIC"). As the Commission is aware, the TELRIC pricing standard was adopted pursuant to Section 252(d)(1) of the Communications Act, which applies only to charges for interconnection and unbundled network elements. As Dr. Fitzsimmons correctly notes, TELRIC was never intended to serve as a pricing mechanism for complete retail services such as special access: it was designed as a theoretical cost model for estimating the costs of UNEs.⁴⁰ As a result, TELRIC should therefore have no application as a proxy for what "competitive" special access rates would be.⁴¹

As the Commission is also aware, TELRIC has been applied in a dubious and inconsistent manner by state regulators, in a contentious process that has been critically marred by inaccurate data and highly theoretical cost models. The variability in the prices produced by these proceedings demonstrates TELRIC's vulnerability to subjective opinions and wide variations as to economic values and models. As Dr. Fitzsimmons shows, these flaws in

pinpoint citation to the correct reference in the *1991 Reconsideration Order* that was apparently intended); *see also* Verizon Comments at 18-19, 39-40; BellSouth Comments at 5, 7-13; USTA Comments at 11-13; CenturyTel Comments at 4-5, *citing Jurisdictional Separations and Referral to the Federal-State Joint Board*, Report and Order, 16 FCC Rcd 11382, 11388-91 ¶¶ 10-14 (2001) (freezing the accounting allocations of price cap LECs).

³⁹ *See* Fitzsimmons Reply Declaration at 1-9; *see also* Fitzsimmons Initial Declaration at 1-2.

⁴⁰ Fitzsimmons Reply Declaration at 12-13.

⁴¹ *Id.*

TELRIC have produced strange and unjustifiable results, such as one state pricing the same network element at less than half the rate in an adjacent state, using the same methodology.⁴² Qwest has also shown in the Commission's TELRIC proceeding, the application of TELRIC to UNEs has frequently resulted in below-cost rates.⁴³ Setting rates at TELRIC would therefore undermine incentives for facilities-based deployment by CLECs and incumbent LECs, and will devalue the facilities that carriers have already deployed. Indeed, re-initializing special access rates would conflict with the Commission's reliance on incentive regulation beginning more than 15 years ago.⁴⁴

Current prices for special access have their origins in historical cost. If the Commission were to re-initialize special access rates according to LRIC, special access prices would be noticeably reduced.⁴⁵ If the rate of return were based on the accounting costs of price cap LECs, such as ARMIS data, setting prices on LRIC could cause a significant decline in earnings, could devalue existing LEC and CLEC investments and reduce incentives for future investment.⁴⁶ As Qwest demonstrated in its initial comments, Qwest's current special access rates in regulated markets have already been driven significantly downward by mechanisms such as the CALLS Plan. Re-initializing special access rates based on regulatory cost-based pricing such as TELRIC is therefore neither justified nor appropriate.

⁴² *Id.* at 13.

⁴³ *See, e.g.,* Qwest Comments in WC Docket No. 03-173 (filed Dec. 16, 2003) at 6, 11-14.

⁴⁴ *See* Verizon Comments at 39-40.

⁴⁵ The explicit goal of some proponents of re-initialization is to make special access prices comparable to those for UNEs. *See* ATX Comments at 18-22.

⁴⁶ *See* Fitzsimmons Reply Declaration at 11-13, 14.

Lastly, Qwest agrees that re-regulating the special access rates of price cap carriers would be a sweeping reversal of the Commission's long-term policies towards price cap carriers.⁴⁷ For years, the Commission has deliberately and increasingly focused on competitive market forces, deregulation and flexibility rather than intensive regulatory control of special access services.⁴⁸ If the Commission were now to depart from these policies and backtrack -- which is explicitly what the proponents of re-initialization are asking the Commission to do -- the Commission's reversal would create turmoil in the special access market, and would upend the business plans of most price cap LECs. Re-initialization of special access rates would administer a serious financial shock to many price cap LECs, particularly if the use of a TELRIC rate-setting methodology or UNE pricing produced prices that were set below the costs of their providers.⁴⁹ In addition to being highly disruptive, such a policy reversal would be highly burdensome for the Commission and the telecommunications industry to implement. Based on these facts, the Commission should reject such a radical reversal of its previous policies.

V. THE COMMISSION SHOULD NOT REINSTITUTE REVENUE SHARING

In the *Notice*, the Commission made a preliminary conclusion that earnings sharing should not be reinstated as part of a new price cap regime for special access.⁵⁰ Three parties argue that the Commission is wrong and that it should in fact reinstate a form of revenue sharing.⁵¹ The common feature of their proposals is that any revenues that a price cap LEC earns

⁴⁷ *Accord*, Verizon Comments at 39-41; BellSouth Comments at 4.

⁴⁸ *See* Iowa Telecom/Valor Comments at 21-23.

⁴⁹ *See* 12 FCC Rcd at 16107 ¶ 290 (noting problem of "rate shock" that would accompany large special access charge reductions that are introduced at one time).

⁵⁰ *See Notice*, 20 FCC Rcd at 2011 ¶ 44.

⁵¹ *See* Ad Hoc Comments at 48-50; ATX Comments at 26-27; PAETEC Comments at 18-19.

above a certain pre-determined level would once again be taken back and “shared” with its end users.⁵²

Qwest strongly disagrees. The Commission is correct that there should be no sharing of earnings if the Commission continues price cap regulation of any special access services. Sharing is a thoroughly discredited regulatory mechanism that the Commission discarded for good reason.⁵³ It should not be revived. In eliminating sharing in 1997, the Commission found that sharing did not work as it was intended, that it created perverse incentives for carriers to shift costs, and that it blunted the incentives of price cap regulation by reducing any rewards for incumbent LEC efficiency gains.⁵⁴ These conclusions are as valid as they were seven years ago.

The record in this proceeding provides no basis for estimating a meaningful rate of return for special access services. As discussed above, it is also clear that the Commission cannot accurately determine the productivity of a single, individual service such as special access. Given these facts, it is clear that a policy of requiring revenue sharing above a pre-selected rate of return would be inherently arbitrary -- particularly if it is based on ARMIS data or TELRIC methodology. As Dr. Fitzsimmons shows in detail, ARMIS data and TELRIC are unsuitable for this purpose.⁵⁵

The proponents of reinstating an earnings sharing system offer few policy rationales for re-adopting the policy, other than pushing forward arguments that the Commission has already

⁵² *Id.*

⁵³ *See Notice*, 20 FCC Rcd at 2010-11 ¶¶ 41-44, *citing Price Cap Review for Local Exchange Carriers*, Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262, 12 FCC Rcd 16642, 16700 ¶ 148 (1997), *aff'd in part and rev'd in part*, *United States Telecom Ass'n v. FCC*, 188 F.3d 521 (D.C. Cir. 1999) (“1997 Price Cap Review Order”).

⁵⁴ *Id.*

⁵⁵ *See Fitzsimmons Reply Declaration* at 1-9, 12-14.

rejected -- such as claiming that sharing serves as a “backstop” on excessive price caps or that sharing ensures against cost padding by price cap LECs.⁵⁶ Alternatively, Ad Hoc suggests that the harmful effects of sharing are not as bad as the Commission concluded in 1997 -- and that even if sharing is harmful, its benefits to “ratepayers and the economy as a whole” outweigh the damage to carriers.⁵⁷ None of these weakly-reasoned arguments give the Commission any reason to reverse its prior determinations that sharing is a defective policy.

For these reasons, the Commission should adopt its tentative conclusion that it should not require LECs to share their earnings as part of a new price cap plan for special access services.⁵⁸

VI. THE COMMISSION SHOULD NOT LIMIT THE LOW-END ADJUSTMENT

In the *Notice*, the Commission states its preliminary conclusion that if it adopts a new price cap plan for special access services, it should retain a low-end adjustment mechanism for LECs that have not implemented Phase I or Phase II pricing flexibility.⁵⁹ Qwest agreed with this position in its initial comments, but stated that the Commission should go further, and should extend the low-end adjustment to all price cap LECs whose earnings drop below the Commission’s minimum rate of return, regardless of whether or not they have obtained pricing flexibility.⁶⁰

⁵⁶ See *1997 Price Cap Review Order*, 12 FCC Rcd at 16699-703 ¶¶ 147-55.

⁵⁷ See Ad Hoc Comments at 49.

⁵⁸ See *Notice*, 20 FCC Rcd at 2010-11 ¶¶ 43-44.

⁵⁹ See *id.* at 2011 ¶ 47.

⁶⁰ See Qwest Comments at 17-18. This assumes that the Commission can even estimate a rate of return for special access services that is not arbitrary. Given the lack of reliable and representative data and the separations problems discussed in Qwest’s reply comments and in Dr. Fitzsimmons’ Reply Declaration, it is clear that the data required to accurately estimate special access rates of return are not available and would be difficult to create.

Qwest disagrees with ATX that a price cap LEC should lose all eligibility for a low-end adjustment on its special access services as soon as it obtains pricing flexibility in any market.⁶¹ If the Commission significantly changes the pricing flexibility regime, then it should reinstitute a low-end adjustment that applies to all price cap special access services, regardless of whether those services are subject to pricing flexibility in a different market. As Qwest has demonstrated, carriers should not be financially penalized for having previously obtained pricing flexibility if the Commission scales it back or alters the previous trade-off of risks and benefits under which the carriers had made their election.⁶² It does not serve the public interest for any price cap LEC to lose their access to the low-end adjustment if they are no longer able to recoup their financial shortfalls in areas that are not subject to price caps.

Qwest also disagrees with ATX that if the Commission adopts a low-end adjustment for price cap special access rates, the adjustment should be set lower than a 10.25 percent rate of return.⁶³ ATX offers no justification for setting the low-end adjustment at this level, other than its apparent reliance on discredited claims that the current rate of return is too high, as well as ATX's overarching claim that special access rates should be re-initialized at a still lower level established under TELRIC methodologies. These are insufficient reasons. As Iowa Telecom correctly points out, the Commission correctly reasoned in the past that carriers earning below a 10.25 percent rate of return on their price cap special access services are likely to be in financial trouble, since it will impair their ability to attract capital and provide services.⁶⁴

⁶¹ See ATX Comments at 27-28.

⁶² See Qwest Comments at 18.

⁶³ *Id.*

⁶⁴ See Iowa Telecom/Valor Comments at 32, *citing Notice* at ¶ 45 (20 FCC Rcd at 2011). In turn, the *Notice* cites the Commission's past determination in *In the Matter of Policy and Rules*

VII. CONCLUSION

For the reasons described herein, the Commission should defer ruling on the issues raised in the *Notice* until it has concluded its review of the SBC-AT&T and Verizon-MCI mergers. Until that time, it is impossible for the Commission to assess the state of competition in special access markets in SBC and Verizon's local service territories. When it undertakes this analysis, the Commission must determine whether competitive conditions are sufficient to constrain special access pricing. The ARMIS rate of return and special access pricing data submitted by the CLECs and other commenters should have no bearing on this analysis. To the extent the Commission adopts a new price cap regulatory regime for special access services, the Commission should not adopt an X-factor that is specific to special access services and should not re-initialize special access rates. Likewise, the Commission should not reinstitute revenue sharing, and should provide a low-end adjustment available to price cap LECs regardless of whether they have obtained pricing flexibility in a different market.

Respectfully submitted,

QWEST COMMUNICATIONS
INTERNATIONAL INC.

By: /s/ Craig J. Brown
Blair A. Rosenthal
Craig J. Brown
Michael B. Adams, Jr.
Suite 950
607 14th Street, N.W.
Washington, DC 20005
(303) 383-6649

Its Attorneys

July 29, 2005

Concerning Rates for Dominant Carriers, Second Report and Order, 5 FCC Rcd 6786, 6806-07 ¶¶ 164-65 (1990).

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

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

Reply Declaration of
Dr. William Fitzsimmons
on Behalf of
Qwest Communications International Inc.

July 29, 2005

I.	Introduction.....	1
II.	ARMIS Data Do Not Provide Meaningful Estimates of Special Access Rates of Return	1
	A. ARMIS Data Served a Different Purpose.....	2
	B. The Trend in ARMIS Data is Toward Greater Inconsistency	3
	C. Other Uses of ARMIS Data Do Not Validate Meaningless Calculations	6
	D. Ad Hoc Committee’s Results Demonstrate That ARMIS Data Are Not Suitable for Calculating Rates of Return for Specific Baskets of Services	6
	1. Variance in Results Demonstrates the Unsuitability of ARMIS Data	6
	2. Implied Rates of Return for Non-Special Access Interstate Services Demonstrate The Unsuitability of ARMIS Data	9
III.	Changes in Tariff Prices Are Not Meaningful Evidence of Market Power.....	10
	A. Tariff Prices Are Higher Than Average Prices.....	10
	B. Price Increases Alone Would Not Indicate Supra-Competitive Pricing	10
IV.	Recommendations Advocated by the Ad Hoc Committee Are Inappropriate	11
	A. Re-initializing Prices	11
	B. Sharing.....	14
	C. Special Access Specific X-Factor	14
	D. Ad Hoc Committee’s Recommendations Pose a Threat to Future Investment.....	15
V.	Conclusion	16

I. INTRODUCTION

My name is William Fitzsimmons. I am the same Dr. Fitzsimmons who previously filed a declaration with the Commission in this proceeding. In this declaration, I respond primarily to claims by the Ad Hoc Telecommunications Users Committee (“Ad Hoc Committee”) that: (1) flawed ARMIS data can be used to calculate meaningful estimates of rates of return for interstate special access services offered by the Bell Operating Companies (“BOCs”); (2) a superficial examination of BOC price changes is meaningful evidence of undue market power; and (3) this Commission should disrupt special access markets based on these flawed analyses of market power.

With the Telecommunications Act, we committed as a nation to promote competition and reduce regulation. This is a difficult, and often uncertain, process that requires a firm commitment to the careful examination of meaningful information. The Ad Hoc Committee contends that the FCC was incorrect when it decided that competitive conditions justified the relaxation of regulatory intervention. Rather than base this contention on a careful and thorough examination of competitive conditions, however, the Ad Hoc Committee offers seriously flawed analyses of BOC rates of return and special access pricing. In the final analysis, the Ad Hoc Committee’s use of meaningless information about interstate special access rates of return and a superficial look at BOC pricing is a counterproductive distraction from a thorough examination of competitive conditions in interstate special access markets.

II. ARMIS DATA DO NOT PROVIDE MEANINGFUL ESTIMATES OF SPECIAL ACCESS RATES OF RETURN

The Ad Hoc Committee’s claim that BOC interstate special access prices are too high rests largely on rate of return estimates that it calculated from ARMIS data. A critical flaw in this analysis stems from the fact that ARMIS data do not provide meaningful estimates of rates of return for interstate special access services. As described in my earlier declaration, the expenses and net investments allocated to interstate special access services in ARMIS are inconsistent with cost causation, and they are inconsistent with the

revenues allocated to these services. Furthermore, accelerated technological change and a freeze of the factors used in the separations process have compounded the problem with ARMIS data considerably. In the final analysis, calculating interstate special access rates of return with ARMIS data is a bit like trying to make omelets with ping pong balls. A passing similarity may tempt a chef with no eggs available to make do with ping pong balls, but the final product from such a substitution would prove unsatisfactory, to say the least. Using ARMIS data that are not suited to the task is, likewise, a nonsensical exercise that produces unpalatable results. Nonetheless, the Ad Hoc Committee asserts that “criticism of earnings results based on ARMIS data must be dismissed in this instance for a number of reasons.”¹ In the remainder of this section, I explain why this statement is incorrect.

A. ARMIS DATA SERVED A DIFFERENT PURPOSE

The first reason given by the Ad Hoc Committee is that “ARMIS financial results simply document the costing and accounting rules that have been implemented by the Commission over several decades.”² Although this may be an accurate observation, it is hardly evidence that ARMIS data provide meaningful estimates of rates of return for the interstate special access service basket. To the contrary, it highlights the point that the process of separating costs in ARMIS was never designed for estimating accurate rates of return for specific categories of service, such as interstate special access. As described in my earlier declaration:

The process of jurisdictional separations . . . is essentially an accounting process that was designed to ensure that *the* phone company recovered its costs, including a regulated rate of return, but that it did not recover the same costs in both the interstate and intrastate jurisdictions. . . . Although separations served the purpose that it was designed for, it does not provide useful information for regulating services in the world of today or tomorrow. [p. 4]

It is noteworthy that the Commission never used ARMIS data to examine rates of return for specific service categories to determine whether

¹ Ad Hoc Committee Comments at 28.

² *Id.* at 29.

adjustments were needed to LEC prices.³ To do so credibly would require a re-examination of the numerous policy judgments about cost allocations to determine how well they have tracked the decades of fundamental changes to telecommunications technology and shifts in demand. [p. 2]

For decades, cost allocations served valid regulatory goals, and reaching these goals did not depend upon accurate cost allocations that were based upon the careful analysis of cost causation. In fact, a look at the implicit subsidy structure that was supported by decades of cost allocations demonstrates that substantial amounts of costs were allocated for reasons other than cost causation. Within the context of the relatively stable economic environment that prevailed at one time in telecommunications markets, this process was deemed acceptable by the BOCs and regulators. It is folly, however, to claim that costs that have their genesis in an allocation process that supported widespread cross subsidies now provide a basis for accurate estimates of interstate special access rates of return. ARMIS data do not provide a sound basis for estimating rates of return for interstate special access services, and they certainly do not support proposed actions by the FCC that would disrupt special access markets.

The Ad Hoc Committee also observes that the ILECs played a large role in generating ARMIS data and that “now is hardly the time to complain” about the misuse of these data. To the contrary, when data that were created for one purpose are misused for another purpose, it is precisely the time to complain.

B. THE TREND IN ARMIS DATA IS TOWARD GREATER INCONSISTENCY

Next, the Ad Hoc Committee claims that “whether or not ARMIS data includes minor cost mis-allocations [sic] at the margins does not affect the overall integrity of the trends in the data, since those alleged mis-allocations [sic] do not change from period to period.”⁴ Aside from the totally unsupported and counterfactual claim about minor

³ *In the Matter of 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, WC Docket No. 05-25, RM-10593, 20 FCC Rcd 1994, 2015 ¶ 62 (“Notice”).

⁴ Ad Hoc Committee Comments at 29.

misallocations, the Ad Hoc Committee's claim that trends of rates of returns calculated from these data are reliable demonstrates a fundamental misunderstanding of the allocation process for ARMIS data. As stated in my earlier declaration:

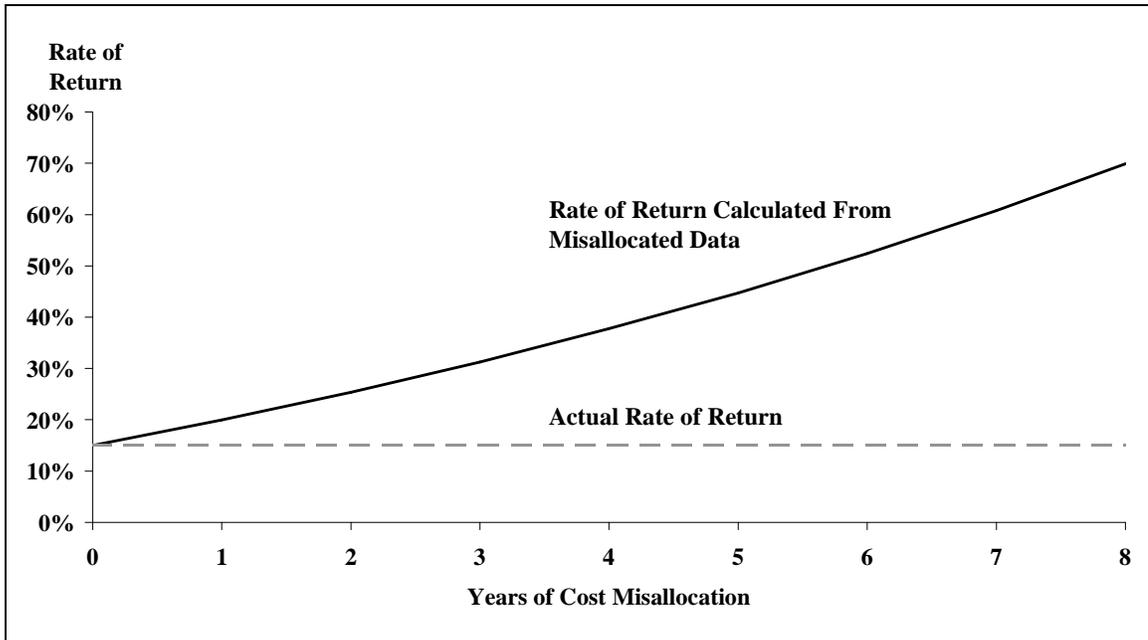
The first principle in cost estimation is cost causation. Costs that are caused by providing a service plus a reasonable share of common costs are the appropriate costs to assign to a service. To the extent that this was ever the goal of the separations process that produced the ARMIS cost estimates, freezes in the separations process . . . have resulted in arbitrary cost allocations that bear little relationship to cost causation. [p. 2]

It is clear that the separations freeze since 2001 has not allowed the allocation process to keep pace with the accelerated changes in technology and customer demand since that time . . . indeed, one of the reasons for the current freeze to the separations process is the difficulty of keeping up with the increased usage of packet switching.⁵ [pp. 2-4]

The freeze of separations factors in 2001 was motivated in part by the difficulties involved with allocating costs in a rapidly changing environment. This freeze and the continued acceleration of technological change since 2001 have steadily exacerbated the inconsistency between interstate special access revenue and cost data. For example, as described in my earlier declaration, all of the revenue from the BOCs' rapidly growing DSL services are allocated to interstate special access, but, due to the freeze in separations, only a portion of the expenses and investments caused by providing DSL follow these revenues. Growing inconsistencies from this and other sources should dispel any remnants of the belief that ARMIS data provide a meaningful basis for estimating interstate special access rates of return. The following illustrative example demonstrates the obvious point that an inconsistent allocation of revenues and costs renders the resulting data useless for estimating a meaningful rate of return.

⁵ *In the Matter of Jurisdictional Separations and Referral to the Federal-State Joint Board*, CC Docket No. 80-286, Report and Order, 16 FCC Rcd 11382, 11383 ¶ 12 (2001).

**Figure 1. Illustrative Rate of Return Calculations
In the Presence of Cost Misallocations**



In this illustrative example: (1) the true and constant rate of return for a fictional service is 15 percent; (2) the revenues and costs properly attributed to the service grow at 20 percent per year; and (3) one-half of the costs going forward from year 0 are misallocated. As a result of the misallocation of one-half of the growth in cost, the calculated rate of return by Year 8 is almost 70 percent, which is more than four times the true rate of return. This simple example demonstrates how cost misallocations can cause significant distortions in the calculated rates of return, and it demonstrates that trends in rates of return calculated from flawed data are equally flawed. In this example, the separations factors are the same in year zero as they are in year 8, and yet the size of the error in the rate of return calculation grows each year. Although it is simple to calculate rates of return from flawed data and present these results in tables and charts, the results are nonsensical and certainly unsuitable for reversing the transition from regulation to competition in interstate special access markets.

C. OTHER USES OF ARMIS DATA DO NOT VALIDATE MEANINGLESS CALCULATIONS

Third, the Ad Hoc Committee states that criticisms of interstate special access rates of return calculated from ARMIS data should be dismissed because the BOCs have used ARMIS data to create benchmarks for examining unbundled network element prices for loops and the components of plain old telephone service (“POTS”). This is a spurious argument. Whether or not ARMIS data provide meaningful information in another context has no bearing on the fact that they are unsuitable for estimating interstate special access rates of return. Relying on this type of innuendo only serves to demonstrate that there is no legitimate rationale for using ARMIS data to estimate interstate special access rates of return.

D. AD HOC COMMITTEE’S RESULTS DEMONSTRATE THAT ARMIS DATA ARE NOT SUITABLE FOR CALCULATING RATES OF RETURN FOR SPECIFIC BASKETS OF SERVICES

When conducting financial analysis, it is important to subject the results to sanity checks. Results of properly conducted analyses that diverge significantly from expectations either provide opportunities for gaining new insights into reality or indicate that there are significant flaws in the data. The process of identifying results that diverge from expectations and investigating the sources of the discrepancies is, in fact, what distinguishes proper financial analysis from the simple act of “crunching” numbers through formulas. As described below, the results presented in the Ad Hoc Committee’s comments diverge from rational expectations, and relatively simple investigations reveal that the reason for this is that ARMIS data are not suited to the task of estimating rates of return for specific categories of services.

1. VARIANCE IN RESULTS DEMONSTRATES THE UNSUITABILITY OF ARMIS DATA

In Figure 2 of its comments, the Ad Hoc Committee presents a bar chart showing interstate special access rates of return for BellSouth, Qwest, SBC and Verizon.⁶ Along with the unbelievable rates of return (approximately 80 percent) portrayed for BellSouth,

⁶ Ad Hoc Committee Comments at 17.

Qwest, and SBC, the figure also shows a dramatic disparity between the rate of return calculated for Verizon (approximately 30 percent) and the rates of return for the other three. Generally, such a wide variance in the results indicates either that there is something important to be learned from further investigation or that there is a significant flaw in the underlying data. In this instance, it appears certain that the variance is due to the process for allocating ARMIS data, which includes room for wide variations in interpretation and is unsuited to the purpose of estimating meaningful interstate rates of return.

FCC Part 65 Rules define the procedure to estimate annual accounting rates of return as follows:

$$\text{Rate of Return} = (\text{Revenue} - \text{Expense} - \text{Taxes}) / \text{Average Net Investment}.^7$$

As shown in this formula, higher revenues increase the rate of return, while higher expenses and investments have the opposite effect. Figure 2, provides the relevant inputs to the rate of return formula from the 2004 ARMIS data for Verizon and the average of the other three BOCs. Verizon's revenue per voice grade equivalent was somewhat higher than the average of the other BOCs, but Verizon's expenses and net assets per access line equivalent were much higher.⁸

⁷ 47 U.S.C § 65.

⁸ The data used by the Ad Hoc Committee included both BOC and non-BOC holding companies. I have restated the data to only include BOC holding companies.

**Figure 2. BOC Interstate Special Access
Rates of Return Calculated From ARMIS Data**

BOC Interstate Special Access Rates of Return Calculated From ARMIS Data			
	Verizon	All Other RBOCs	Difference
Rate of Return	24%	78%	-54%
Revenue Per Line	\$141	\$104	\$38
Expense Per Line	\$110	\$63	\$48
"Return" Per Line	\$31	\$41	-\$10
Net Assets Per Line	\$130	\$53	\$78

Note: Lines are defined as voice grade equivalents per ARMIS definition.
Sources: ARMIS 43-01, 43-04, and 43-08.

Given Verizon’s revenue per voice grade equivalent advantage, and the rational expectation that all of the BOCs would operate at reasonably similar levels of efficiency, the expected result would be for Verizon to have a rate of return that is at least on par with the other BOCs. This is not the result of the ARMIS-based calculations because the expenses and investment levels allocated to special access for Verizon are very much higher than the remaining BOCs. It is certainly difficult to imagine a believable real-world phenomenon to explain such a disparity in expenses and investments. The geographic cost characteristics (i.e., density) of Verizon’s service territory cannot explain this disparity, and there is no reason why Verizon could not adopt the technical efficiencies of its counterparts. The most reasonable conclusion is that the process for allocating the underlying ARMIS data, which includes room for wide variations in interpretation, is unsuited to the purpose of estimating meaningful interstate rates of return.

2. IMPLIED RATES OF RETURN FOR NON-SPECIAL ACCESS INTERSTATE SERVICES DEMONSTRATE THE UNSUITABILITY OF ARMIS DATA

In Figure 4 of its comments, the Ad Hoc Committee shows trends in rates of return calculated from ARMIS data, which it contends show that special access rates of return are growing more unbelievable every year. This figure also shows that overall interstate special access rates of return calculated from ARMIS data have remained relatively flat by comparison, and were approximately 19 percent in 2004.⁹ What is not shown in the figure is the average rate of return calculated from the ARMIS data for the BOCs' remaining interstate services which are also unbelievable, as shown below.

Figure 3. BOC Rates of Return Calculated From ARMIS Data

BOC Rates of Return Calculated From ARMIS Data			
	Verizon	All Other RBOCs	All RBOCs
All Interstate	11%	23%	19%
Interstate Special Access	24%	78%	52%
All Other Interstate	1%	3%	2%
<i>Source: ARMIS 43-04.</i>			

The necessary, though highly unlikely, implication of the Ad Hoc Committee's claim is that the BOCs are realizing interstate rates of return for non-special access services that are close to zero. Once again, the proper interpretation of this analysis is that ARMIS data are not suitable for estimating meaningful rates of return for specific baskets of services. Even at the relatively aggregated level of interstate services, arbitrary allocations and the separations freeze in 2001 make these data unsuitable for estimating rates of return. Examining rates of return below this level of aggregation is a meaningless exercise.

⁹ As described in my earlier declaration, the disparate treatment of DSL revenues and costs is artificially increasing interstate rates of return calculated from ARMIS data. See Fitzsimmons Initial Declaration at 2-3.

III. CHANGES IN TARIFF PRICES ARE NOT MEANINGFUL EVIDENCE OF MARKET POWER

The Ad Hoc Committee puts forth a superficial, incomplete, and essentially meaningless analysis of BOC prices to support its contention that increased pricing flexibility was not warranted by the market conditions. The Ad Hoc Committee readily acknowledges the prevalence of term and volume discounts and yet maintains that changes in tariff prices, that do not reflect these discounts, are meaningful. Furthermore, even if it were true that certain special access prices are increasing in areas with pricing flexibility, in the absence of any evidence or reasonable expectation that these prices are above cost, price increases in and of themselves demonstrate nothing about market power. A careful examination of prices relative to costs, that accounts for term and volume discounts and changes in how services are produced and purchased, could shed useful light on the analysis of market power. The cursory analysis by the Ad Hoc Committee only muddies the water.

A. TARIFF PRICES ARE HIGHER THAN AVERAGE PRICES

Changes in tariff prices have little to no relevance in the assessment of market power in special access markets, because the vast majority of special access services are purchased by large entities, most of which are carriers, and these entities negotiate term and volume discounts. Tariff prices are, therefore, higher than average prices.

Qwest's largest customers of special access services are all telecommunications carriers. By aggregating customer demand, these carriers are able to negotiate term and volume discounts and pass portions of these discounts on to their end users. The benefits of this strategy extend to all customers, including end users who purchase special access services from Qwest. All, or almost all, Qwest end-user customers of special access services are potential customers of the carriers that purchase special access services from Qwest.

B. PRICE INCREASES ALONE WOULD NOT INDICATE SUPRA-COMPETITIVE PRICING

Even if it were true that average prices increased for certain special access services in areas with increased pricing flexibility, this is not evidence of market power. Special access services have been subjected to decades of price regulation. It is possible and

likely that special access prices, that resulted from decades of regulation, including the price reductions after the adoption of the CALLS plan that were best described as arbitrary, bear little resemblance to prices that would prevail in a competitive market.

If this Commission chooses to examine changes in average prices for special access services, it will also need to consider the dimensions of the special access services purchased that may have increased the underlying costs of providing service. Average costs and prices may increase across time, for example, if the average circuit distances increase and/or carriers on average purchase greater amounts of multiplexing equipment. Revenue increases that are accompanied by cost increases are not evidence of market power.

IV. RECOMMENDATIONS ADVOCATED BY THE AD HOC COMMITTEE ARE INAPPROPRIATE

Granting greater pricing flexibility in 1999 was a step in the twenty-year transition from regulation toward competition in special access markets. Based on seriously flawed analyses of rates of returns and prices, the Ad Hoc Committee recommends turning back the regulatory clock on these efforts, not just to 1999, but to the de facto rate-of-return regulation that existed in the late 1980s. With no credible evidence that any correction to the current course is even required, the Ad Hoc Committee recommends: (1) resetting special access prices based upon a specified rate of return; (2) returning to sharing requirements that were imposed in the early days of price caps and discarded by the Commission in 1997; and (3) taking the impractical and unprecedented step of devising a productivity offset that is specific to special access services. The Ad Hoc Committee recommends these drastic remedies without offering any meaningful evidence that a problem exists. This is a prescription for regulatory morass and market disaster.

A. RE-INITIALIZING PRICES

The Ad Hoc Committee recommends resetting interstate special access prices based upon an 11.25 percent rate of return. As an initial matter, there is no evidence or reasonable expectation that the BOCs are “over-earning,” and effort spent considering drastic measures to solve a hypothetical (and unlikely) problem is better spent elsewhere, such as

in the careful examination of market conditions. It is certainly ill-advised to overturn decades of progress toward competitive markets with no meaningful evidence that we are on the wrong track.

The Ad Hoc Committee's recommendation is for a return to rate-of-return regulation, with the limited and perverse incentives that provided the motivation for regulatory progress over twenty years ago. Price cap regulation was a transition step toward releasing the incentives that drive consumer benefits throughout our economy and toward flexible pricing capable of providing real-time signals to consumers and producers in response to changing market conditions. It was a recognition that rate-of-return prices, even those devised by the wisest of regulators, cannot hope to simulate the fluid pricing that is the lifeblood of efficient competitive markets and the stimulus for efficient and beneficial innovation and investment.

Not only is the Ad Hoc Committee's proposal reactionary and unsuited to stimulating investment in today's markets, it would also prove difficult, if not impossible, to implement in a timely and accurate manner. First, in spite of the Ad Hoc Committee's claim that an 11.25 percent rate of return "is likely an extremely generous mark," resetting prices would require an in-depth analysis to determine an appropriate rate of return.¹⁰ As observed by the Commission in the Triennial Review Order, "increased competition would lead to increased risk, which would warrant an increased cost of capital."¹¹ Second, even if this Commission decided to return special access services to rate-of-return regulation and put forward the effort to determine an appropriate rate of return, applying a specific rate of return to special access would require accurate estimates of special access investment levels and expenses, and these do not exist.

¹⁰ Ad Hoc Committee Comments at 37.

¹¹ *In the Matter of Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, Deployment of Wireline Services Offering Advanced Telecommunications Capability*, Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, 18 FCC Rcd 16978, 17396 ¶ 682 (2003), *vacated in part and remanded in part, United States Telecom Ass'n. v. FCC*, 359 F.3d 554 (D.C. Cir. 2004), *certs. denied*, 125 S. Ct. 313, 316, 345 (2004).

Before leaving the topic of reinitializing prices, comment is warranted on Wiltel's contention that prices should be reset based upon estimates of total element long run incremental costs ("TELRIC").¹² This is another nonsensical prescription for disaster. The TELRIC methodology was designed for a purpose, and this purpose was not to provide a basis for resetting prices of finished services. As demonstrated by nearly eight years of proceedings across the United States, estimating TELRIC is a highly contentious process for estimating the costs of unbundled network elements that BOCs were required to provide to competitive local exchange carriers ("CLECs") only when a lack of access to these elements on an unbundled basis would materially impair the abilities of efficient CLECs to compete effectively. The TELRIC concept contains a number of fundamental assumptions that are contrary to reality, such as the complete replacement of the network at current costs and conditions and no changes in competitive conditions. The TELRIC construct also leaves considerable room for interpretation, and this resulted in a wide variety of cost estimates for the same network elements in different jurisdictions. For example, as shown in Figure 4, the TELRIC-based statewide average price for an unbundled DS3 capable loop in the State of Washington is more than twice the TELRIC-based price of a DS3 capable unbundled loop in the neighboring State of Oregon.

**Figure 4. TELRIC-Based Statewide Average DS3 Capable UNE Loop Prices
in Oregon and Washington**

	DS3 UNE Loop Price	WA Multiple of OR
Oregon	\$363.42	
Washington	\$754.21	2.1

As a transitional measure in the move away from markets characterized by franchise monopolies, TELRIC was perhaps necessary, but its application came at a considerable cost, including a strong disincentive for continued investment in new facilities and capabilities by BOCs. Special access is an increasingly important segment of our telecommunications infrastructure, and we cannot afford to un-tether the prices of these

¹² Wiltel Comments at 16-17.

services from reality by setting them on the basis of a fictional and inaccurate TELRIC methodology.

B. SHARING

All of the pitfalls associated with the Ad Hoc Committee's recommendation to reset prices to a specified rate of return also apply to its recommendation that the Commission should re-impose a sharing requirement. Telecommunications markets worldwide are engaged in the transition from regulation to competition because competitive markets are best suited to delivering consumer benefits from this critical industry. Sharing requirements were implemented along with interstate price caps in the U.S. as a transition step away from rate-of-return regulation. By tying incentive regulation to firms' rates of return, however, these requirements dragged along many of the perverse incentives of rate-of-return regulation into price-cap regulation. The Commission recognized the perverse incentives that accompanied sharing requirements, and it discarded these requirements in 1997.¹³ It is certainly not time to re-infect interstate special access markets with incentives that are clearly out of step with the transition to competitive markets.

C. SPECIAL ACCESS SPECIFIC X-FACTOR

The Ad Hoc Committee recommends imposing a specific productivity factor on the prices for interstate special access services. As with its other recommendations, this recommendation is: (1) not supported with meaningful evidence that this is warranted; and (2) made without recognizing that the information to implement the recommendation does not exist. In this case, information to estimate basket specific productivity estimates does not exist, and it would be difficult, if not impossible, to estimate accurately in a timely manner.

¹³ *In the Matter of Price Cap Performance Review for Local Exchange Carriers, Access Charge Reform*, Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262, 12 FCC Rcd 16642, 16700 ¶ 148 (1997), *rev'd in part and remanded in part on other grounds, United States Telecom Assn' v. FCC*, 188 F.3d 521 (D.C. Cir. 1999).

As demonstrated above, ARMIS data do not provide meaningful evidence of rates of return for specific baskets of services. There is, therefore, no compelling reason to consider a specific productivity offset (“X-factor”) for interstate special access services. Even if it were deemed necessary to devise a special access X-factor, however, it would prove difficult, if not impossible, to estimate productivity at this level of disaggregation. Due to the nature of network economics, productivity studies in telecommunications attempted to estimate the overall productivity achieved across the network and not productivity for sub-groups of services that are produced over the network. Following this recommendation would send the industry down the highly contentious path of arbitrarily allocating costs, with little likelihood of consensus and a high likelihood of destroying incentives to invest.

D. AD HOC COMMITTEE’S RECOMMENDATIONS POSE A THREAT TO FUTURE INVESTMENT

By lowering prices without legitimate cause and creating regulatory uncertainty, the recommendations of the Ad Hoc Committee would pose serious threats to the future of special access markets. In terms of prices, two points are clear: (1) regulated prices have no hope of allowing the pricing flexibility required to maintain the appropriate balance between risks and rewards in special access markets; and (2) there is a serious danger of devaluing current and prospective fiber-based assets for CLECs and ILECs with regulated prices that are set too low.

Unjustified regulatory backtracking, as proposed by the Ad Hoc Committee, would also dampen investment incentives by creating regulatory uncertainty. Decisions by regulators can dramatically affect the outcome of an investment. Because the actual outcome may favor one group of competitors over another, the expected impact of regulatory uncertainty is depressed investment. Whether an incumbent or entrant is using a sophisticated business plan or intuition to assess the viability of an investment, regulatory uncertainty is a cause for concern. When the regulatory uncertainty is related to a major driver of revenue, such as price, many investment decisions are delayed to await clarity. The flawed analyses presented by the Ad Hoc Committee do not even

come close to justifying decisions that would place the future of fiber-based investments by ILECs and CLECs at risk.

V. CONCLUSION

The Ad Hoc Committee strives for an easy path to analyzing the competitive nature of interstate special access markets, but no such path exists. Meaningful financial analysis requires correct equations, accurate data, and sound interpretation of the results. Although the Ad Hoc Committee uses the appropriate equation for calculating rates of return and presents the results in tables and charts, it uses ARMIS data that are so poorly suited to the analysis that the results are no more than attractive nonsense. And although the Ad Hoc Committee looks at prices, ignoring term and volume discounts and comparisons with costs renders the results meaningless.

There is no shortcut for conducting a meaningful analysis of the competitive nature of special access markets. As years of cost and financial analyses of telecommunications have demonstrated, allocating shared and common costs based on cost causation is a very difficult process to do well, and even then it is subject to arbitrary decisions. In a network industry, such as telecommunications, where there are substantial shared costs, it is perhaps prohibitively difficult and contentious to allocate costs that will reveal meaningful rates of return for specific services or service categories. The analysis of special access markets requires a careful designation of product and geographic markets and a meaningful investigation of the facts.

Although it is understandable that large volume customers of special access services, such as the members of the Ad Hoc Committee, would prefer to pay less for these services, the Ad Hoc Committee provides no meaningful analysis to support its claims of supra-competitive interstate special access prices. In the absence of meaningful evidence, its recommendations for resetting prices, reinstating sharing requirements, and implementing a service specific X-factor should be rejected.

CERTIFICATE OF SERVICE

I, Richard Grozier, do hereby certify that I have caused the foregoing **REPLY**
COMMENTS OF QWEST COMMUNICATIONS INTERNATIONAL INC. to be 1) filed
electronically via the FCC's Electronic Comment Filing System in WC Docket No. 05-25,
2) served via e-mail on Ms. Tamara Preiss, Chief, Pricing Policy Division at
Tamara.Preiss@fcc.gov, 3) served via e-mail on Best Copy and Printing, Inc. at
fcc@bcpiweb.com, and 4) served via First Class United States mail, postage prepaid, on the
parties listed on the attached service list.

Richard Grozier
Richard Grozier

July 29, 2005

Bennett L. Ross
BellSouth Corporation
Suite 900
1133 21st Street, N.W.
Washington, DC 20036

Richard M. Sbaratta
J. Phillip Carver
BellSouth Corporation
Suite 4300
675 West Peachtree Street, N.E.
Atlanta, GA 30375

James W. Olson
Indra Sehdev Chalk
Jeffrey S. Lanning
Robin E. Tuttle
United States Telecom Association
Suite 600
607 14th Street, N.W.
Washington, DC 20005

Leonard J. Cali
Judy Sello
AT&T Corp.
Room 3A229
One AT&T Way
Bedminster, NJ 09721

Christopher M. Heimann
Gary L. Phillips
Paul K. Mancini
SBC Communications Inc.
Suite 400
1401 I Street N.W.
Washington, DC 20005

Norina Moy
Richard Juhnke
Sprint Corporation
Suite 400
401 9th Street, N.W.
Washington, DC 20004

Michael H. Pryor.....CompTel/Alts
Mintz, Levin, Cohn, Ferris,
Glovsky and Popeo, PC
Suite 900
701 Pennsylvania Avenue, N.W.
Washington, DC 20004

Jonathan D. Lee
CompTel/ALTS
Suite 800
1900 M Street, N.W.
Washington, DC 20036

Paul Kouroupas
Global Crossing
3rd Floor
200 Park Avenue
Florham Park NJ 07932

Riley M. Murphy
NuVox, Inc.
Two North Main Street
Greenville, SC 29601

Thomas J. Sugrue
Kathleen O'Brien Ham
James W. Hedlund
T-Mobile USA, Inc.
Suite 550
401 Ninth Street, N.W.
Washington, DC 20004

Cheryl A. Tritt
Joan E. Neal
Morrison & Foerster LLP
Suite 5500
2000 Pennsylvania Avenue, N.W.
Washington, DC 20006

Christopher J. Wright.....Broadwing
Timothy J. Simeone
Maureen K. Flooe
Harris, Wiltshire & Grannis LLP
1200 18th Street, N.W.
Washington, DC 20036

Kim D. Larsen
Lawrence E. Strickling
Broadwing Communications, LLC
1122 Capital of Texas Highway South
Austin, TX 78746

Grier C. Raclin
Joanna S. Lowry
Cathleen K. Wasilewski
SAVVIS Communications Corporation
12851 Worldgate Drive
Herndon, VA 20170

Kent Y. Nakamura
Anthony M. Alessi
Nextel Communications, Inc.
2001 Edmund Halley Drive
Reston, VA 20191

Richard Metzger, Jr.....Nextel
Gil M. Strobel
Lawler, Metzger, Milkman & Keeney, LLC
Suite 802
2001 K Street, N.W.
Washington, DC 20006

Edward Shakin
Sherry A. Ingram
Verizon
Suite 500
1515 North Court House Road
Arlington, VA 22201-2909

Jeffrey S. Linder.....Verizon
Rebekah P. Goodheart
Wiley Rein & Fielding LLP
1776 K Street, N.W.
Washington, DC 20006

Colleen Boothby.....Ad Hoc
Levine, Blaszak, Block & Boothby, LLP
Suite 900
2001 L Street, N.W.
Washington, DC 20036

Susan M. Gately.....Ad Hoc
Economics and Technology, Inc.
Suite 400
Two Center Plaza
Boston, MA 02108-1906

Blaine Gilles, Ph.D
WilTel Communications, LLC
Suite 140
9525 W. Bryn Mawr
Rosemont, IL 60018

Adam Kupetsky
WilTel Communications, LLC
TC15
One Technology Center
Tulsa, OK 74103

C. Douglas Jarrett.....API
Kevin G. Rupy
Katherine C. Lucas
Keller and Heckman LLP
Suite 500 West
1001 G Street
Washington, DC 20001

A. Sheba Chacko
BT Americas Inc.
BT Infonet USA
1140 Commerce Park Drive
Reston, VA 20191

Christopher T. McKee
Alaine Miller
XO Communications, Inc.
1111 Sunset Hills Road
Reston, VA 20190

Brad E. Mutschelknaus.....XO Comm
Kimberly A. Scardino
Kelley Drye & Warren LLP
5th Floor
1200 Nineteenth Street, N.W.
Washington, DC 20036

John F. Jones
CenturyTel, Inc.
100 CenturyTel Park Drive
Monroe, LA 71203

Karen Brinkmann.....CenturyTel
Jeffrey A. Marks
Latham & Watkins LLP
Suite 1000
555 Eleventh Street, N.W.
Washington, DC 20004-1304

Seema M. Singh
Ratepayer Advocate
11th Floor
31 Clinton Street
Newark, NJ 07102

Fred Goldstein
Ionary Consulting
POB 610251
Newton Hlds., MA 02461

Thomas Jones.....Time Warner
Jonathan Lechter
Willkie Farr & Gallagher LLP
1875 K Street, N.W.
Washington, DC 20006

Donald G. Henry
Edward B. Krachmer
Iowa Telecommunications Services, Inc.
Newton, IA 50208

William M. Ojile
Valor Telecommunications of Texas, LP
Suite 200
201 E. John Carpenter Freeway
Irving, TX 75062

Gregory J. Vogt.....Iowa/Valor
Bradley K. Gillen
Wiley Rein & Fielding LLP
1776 K Street, N.W.
Washington, DC 20006

Andrew D. Lipman.....ATX, *et al.*
Richard M. Rindler
Patrick J. Donovan
Philip J. Macres
Swidler Berlin LLP
Suite 300
3000 K Street, N.W.
Washington, DC 20007

J.T. Ambrosi
PAETEC Communications, Inc.
One PAETEC Plaza
600 Willowbrook Office Park
Fairport, NY 14450

050729WC0525ReplyCOS.doc
Updates 07/29/05