

Attachment 2

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

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

**Reply Comments of the
Ad Hoc Telecommunications Users Committee**

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SUMMARY

The unprecedented price increases and profit levels at issue in this rulemaking are a sobering reminder that de-regulatory initiatives like the Commission's special access pricing flexibility rules must be grounded in marketplace facts. Premature de-regulation of non-competitive services damages not only the interests of customers, who must pay excessive rates and forego the service quality and innovation characteristic of competitive markets, but the public interest as well because the development of competition can be stymied or impeded by the unregulated exercise of market power.

And there is no question that the current pricing flexibility rules were applied prematurely to the special access market. Though BellSouth, SBC, and Verizon repeatedly refer to the "success" of the Commission's pricing flexibility plan, and the "robust" competition that exists for special access services (in the apparent belief that saying something can make it so), there is no remaining question for anybody but the BOCs as to the fundamentally monopolistic nature of BOC special access services. The BOCs' dogged persistence in asserting that, despite all factual evidence to the contrary, special access is nevertheless "robustly" competitive has no support in the record. If their persistence merely reflects a cynical conviction that repetition of the same lie can trump reality, then it is insulting to the Commission and other decision-makers.

Ad Hoc and various other parties have repeatedly cited the egregiously high – and consistently increasing – prices and rates of return being collected by each of the BOCs on their interstate special access services, with returns topping

out in the 70% to 80% range for the year ended December 2004. Earnings of this magnitude, with uninterrupted growth and steady price increases every year, demonstrate the existence of a persistent monopoly and certainly nothing remotely close to a market that can be described as even modestly competitive.

The only pricing evidence filed in this proceeding, notably by parties other than Qwest, SBC, and Verizon, demonstrates conclusively that prices have increased.

BellSouth, Qwest, SBC, and Verizon argue that any conclusions reached in reliance on the Commission's ARMIS data are unreliable because the jurisdictional separations allocations underlying ARMIS results have been "frozen" since 2001, and ARMIS does not properly match revenues with investments and expenses for DSL service. None of these undocumented arguments is valid because (a) the jurisdictional separations freeze did not apply to directly assigned costs like those underlying special access; and (b) even if all DSL costs are removed from special access categories and all DSL revenues are included (which would be improper under the rules), the BOCs' returns would still be astronomically high.

Instead of retaining its current rules, the Commission should re-specify a special access "X" factor. Contrary to the BOCs' claims that none is needed, the record in this proceeding is rich with data demonstrating the need for a new, higher X-factor. Consistent with two X-factor studies undertaken by Ad Hoc's economic consultants, Economics and Technology, Inc., and documented in

attachments to these Reply Comments, the Commission should adopt an X in the range of 10%.

The Commission should also re-initialize special access rates at non-exploitive levels. The BOCs oppose proposals to re-initialize special access rates with efficiency arguments that are, on their face, ridiculous with respect to the one-time re-initialization contemplated in the *NPRM*, and inconsistent with the capture of efficiency gains in competitive markets. If the competitive conditions in the special access market are not sufficient to ensure that the benefits of efficiency improvements flow through to consumers in the form of lower prices, then regulators must step up to the plate and act as a surrogate for those missing market forces.

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The Ad Hoc Telecommunications Users Committee (“Ad Hoc” or the “Committee”) hereby submits its reply to comments filed in response to the Commission’s January 31, 2005 Order and Notice of Proposed Rulemaking (“*NPRM*”) in the docket captioned above.¹

INTRODUCTION

The members of Ad Hoc are among the nation’s most sophisticated corporate buyers of telecommunications services. Committee members come from a broad range of industry sectors (including manufacturing, financial services, insurance, retail, package delivery, and information technology) and obtain telecommunications services to connect millions of locations in every region of the country. Ad Hoc’s members include fourteen of the “Fortune 500” companies and ten of the “Fortune 100.” They estimate their combined annual

¹ *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, Order and Notice of Proposed Rulemaking, FCC 05-18 (rel. January 31, 2005) (“*NPRM*”).

spend on communications products at between two and three billion dollars per year.

Because Ad Hoc admits no carriers as members and accepts no carrier funding, Ad Hoc members have no commercial self-interest in the imposition of unnecessary regulatory constraints on incumbent service providers and has consistently advocated de-regulation as soon as a service market becomes competitive. But the special access market is simply not competitive enough for market forces to discipline prices and service quality. In its Comments in this docket, Ad Hoc therefore urged the Commission to abandon its failed “pricing flexibility” experiment in order to protect customers of special access services from exploitive rates. Ad Hoc noted that the lack of competition for special access, and the Commission’s continuing failure to regulate this non-competitive market effectively, costs enterprise customers over \$17.5 million dollars per day in excessive charges for the special access services they need.

Most parties who filed comments in this docket confirmed Ad Hoc’s conclusions regarding the dearth of competition for special access services. Only the BOCs would have this Commission ignore the objective evidence that is mounting up in this docket regarding the BOCs’ market power and continuing exploitation of that power to the detriment of access customers.

DISCUSSION

The unprecedented price increases and profit levels at issue in this rulemaking are a sobering reminder that de-regulatory initiatives like the Commission’s special access pricing flexibility rules must be grounded in

marketplace facts. Premature de-regulation of non-competitive services damages not only the interests of customers, who must pay excessive rates and forego the service quality and innovation characteristic of competitive markets, but the public interest as well because the development of competition can be stymied or impeded by the unregulated exercise of market power.

I. Premature Pricing Flexibility Has Allowed the ILECs to Exploit Ratepayers

In the apparent belief that saying something can make it so, BellSouth, SBC, and Verizon repeatedly refer to the “success” of the Commission’s pricing flexibility plan, and the “robust” competition that exists for special access services. Verizon chirps that “[t]he Commission’s progressive deregulation of special access rates has been a regulatory and marketplace success story,” that “prices have dropped, output has increased,....competition has grown...and both special access providers and their customers have benefited from the flexibility afforded by the new rules.”² Blithely ignoring all objective measures of reality, BellSouth asserts that “the special access market is robustly competitive,” and that special access prices have decreased, not increased, since the start of the pricing flexibility regime.³ SBC stoutly maintains that “the current pricing flexibility regime is working,” and also that “the special access market today is vastly more competitive than it was when pricing flexibility was adopted.”⁴

² Verizon Initial Comments at 1.

³ BellSouth Initial Comments at 13 – 14 and 20.

⁴ SBC Initial Comments at 2 and 13.

The BOCs' attempt to describe a special access market so completely at odds with reality would be laughable were it not so disingenuous. No serious observers of this marketplace – from state public utility commissions to CLECs to IXCs to wireless carriers to end users – have been able to identify any competitive entry, market forces, or pricing behavior that remotely resembles the competitive landscape painted so insistently by the BOCs.⁵

In today's marketplace, as evidenced by the Comments filed in this docket, there is no remaining question for anybody but the BOCs as to the fundamentally monopolistic nature of BOC special access services – a condition that will be exacerbated if the proposed mergers of AT&T with SBC and MCI with Verizon go forward since whatever minimal level of competition AT&T introduces for SBC and MCI introduces for Verizon will disappear. From the perspective of enterprise customers who rely upon special access services for mission-critical communications and data applications, the supposed benefits of the special access pricing flexibility regime remain sadly unrealized.

Ad Hoc and various other parties have repeatedly cited the egregiously high – and consistently increasing – prices and rates of return being collected by each of the BOCs on their interstate special access services, with returns topping out in the 70% to 80% range for the year ended December 2004.⁶ Earnings of this magnitude, with uninterrupted growth and steady price increases every year,

⁵ See, e.g., Comments of T-Mobile at 7, Comments of Sprint at 1, Comments of the New Jersey Ratepayer Advocate at 7 (filed June 13, 2005), *Special Access Rates for Price Cap Local Exchange Carriers*, WC Docket No. 05-25.

⁶ Initial Comments of the Ad Hoc Telecommunications Users Committee, *Special Access Rates for Price Cap Local Exchange Carriers*, WC Docket No. 05-25 (filed June 13, 2005) (“*Ad Hoc Initial Comments*”), at 28. Also, T-Mobile Initial Comments at 10-11, and Broadwing/SAVVIS Initial Comments at 2-5 and 10-22.

demonstrate the existence of a persistent monopoly and certainly nothing remotely close to a market that can be described as even modestly competitive. Moreover, the steady increases in the BOCs' prices and profits over several years, with no development of countervailing competitive pressures to push prices and earnings to reasonable levels, demonstrates the intellectual bankruptcy of the "potential competition" theory frequently espoused by the BOCs, under which the exercise of market power to extract creamy monopoly profits is supposedly constrained by the threat of the competitive entry that would be attracted by those very returns (which has yet to materialize in the special access market).

The BOCs' dogged persistence in asserting that, despite all factual evidence to the contrary, special access is nevertheless "robustly" competitive is extraordinary, particularly since they have supported their assertions only with speculation and theoretical musings as to how markets *should* respond to the kind of market power they wield. If their persistence merely reflects a cynical conviction that repetition of this unfounded assertion can trump reality, then it is insulting to the Commission and other decision-makers.

BellSouth, SBC, and Verizon each attempt to refute the evidence of steady price increases for special access with expert analyses purporting to demonstrate that prices have instead been declining since the inception of the Commission's pricing flexibility plan.⁷ Yet in every case, what the BOCs describe

⁷ See, Verizon Initial Comments, Declaration of William E. Taylor at paras. 11 and 16; SBC Initial Comments, Declaration of Parley Casto at paras. 56 – 58; and BellSouth Initial Comments, Attachments 3 and 5.

in their pleadings as evidence of falling “prices” turns out upon review of their supporting attachments to be instead evidence of changes in the “average revenue” (measured on the basis of a meaningless channel equivalency basis) being generated by different services.

The revenue analyses upon which the BOCs rely cannot, of course, refute the pricing evidence introduced by other parties in this record; the “average revenue” being generated by a voice-grade equivalent circuit, or DS1 or DS3 “circuit” is not the same as the price actually charged to customers by the BOCs. Moreover, average revenue is governed by a number of factors unrelated to price, such as the mix of service capacities carriers offer and customers order; changes in customer demand for different term plans; changes over time in the relative relationship of channel termination quantities, entrance facilities, and interoffice facilities comprising the average circuit configuration; changes in the average length of circuit where distance-sensitive channel mileage rate elements apply; and the functioning of the Commission’s required reductions under the price caps plan.

Thus, a change in “average revenue” does not equate to a change in average price. Consider, for example, a situation in which a customer purchasing two DS3 circuits initially has both circuits multiplexed down into multiple DS1’s. The customer’s requirements change – thanks to changes in CPE technology, the customer’s internal processes, or organic growth in its business – so that the customer now requires the full bandwidth capability of one of the DS3s and it therefore eliminates multiplexing functions from the circuit

configuration for one circuit. That change in circuit configuration would result in a reduction in the “average revenue” being generated by those circuits though the BOC would have made no changes to its prices.

The only pricing evidence filed in this proceeding, notably by parties other than Qwest, SBC, and Verizon, demonstrates conclusively that prices have increased. Ad Hoc and other non-BOCs provided in their comments detailed pricing data based upon actual, filed rate elements. Ad Hoc documented substantial differences between the price levels applicable in areas in which pricing flexibility has been granted, and price levels in price caps regulated areas.⁸ Ad Hoc’s comments also documented examples of out-right increases in the rate element prices in the BOCs’ pricing flexibility tariffs, and also revealed that even in instances where the rate element price levels were not increased in the pricing flexibility tariffs, they had remained constant since the introduction of pricing flexibility in 2001, despite decreasing costs during that time frame. Ad Hoc documented examples of actual increases in a wide variety of rate elements, many of which had been sustained for as long as three years (some longer).⁹ Global Crossing also introduced *actual* pricing evidence demonstrating rate increases through the declaration of its Director of Access Regulatory- Janet S. Fischer.¹⁰

Perhaps the most compelling *actual* price evidence was offered by Sprint. Sprint analyzed the prices it was paying for the actual special access facilities it

⁸ AdHoc Initial Comments at 16 – 26, and associated attachments.

⁹ AdHoc Initial Comments at 16 -20.

¹⁰ Declaration of Janet S. Fischer, Initial Comments of Global Crossing North America, Inc., June 13, 2005.

was purchasing (under six-year term contracts) from the BOCs in areas in which pricing flexibility had been granted, and *repriced* those same services at the price levels that would have applied had the services instead been located in areas where pricing flexibility has not been granted. Sprint's real life experience with its real network is that the prices it is paying were \$103-million higher in 2004 than they would have been if the services had not been offered through the pricing flexibility tariffs.¹¹

II. BOC Criticisms Of ARMIS Are Unfounded

The comments of BellSouth, Qwest, SBC, and Verizon reflect a consensus among those companies (and only those companies) that any calculations or conclusions reached through analysis of the Commission's ARMIS data cannot be usefully employed to analyze the performance or the BOCs in the special access market. The BOCs' primary ARMIS criticism's fall into three categories:

- ARMIS reflects allocations of embedded accounting costs that have no place in rate-setting as a general matter, and particularly not in a vibrantly competitive market like that for special access services;¹²
- The jurisdictional separations allocations underlying ARMIS results have been "frozen" since 2001, with the result that they no longer accurately reflect special access investments or expenses;¹³ and

¹¹ Sprint Initial Comments at 5.

¹² See, Verizon Initial Comments, Declaration of William E. Taylor at para. 92; BellSouth Initial Comments, Declaration of Harold Furchtgott-Roth and Jerry Hausman at para. 39; SBC Initial Comments, Declaration of Joseph P. Kalt at para. 80.

¹³ See, SBC Initial Comments, Declaration of Joseph P. Kalt at para. 80; SBC Initial Comments, Declaration of David Toti at paras. 4, 17 and 21.

- ARMIS contains a fundamental mismatch between the revenues and the investments and expenses associated with DSL service, fatally distorting any earnings results for the special access category.¹⁴

None of these arguments is valid, and none is sufficient to explain away the astronomical earnings realized by the BOCs from their supposedly competitive special access services.

The BOCs have long argued that return figures – which are derived from data filed by the BOCs themselves with the FCC’s ARMIS database – are simply wrong because ARMIS itself is an outdated regulatory accounting regime. In this proceeding, BellSouth characterizes it as “irrelevant accounting information”,¹⁵ Verizon and Qwest describes it as “arbitrary”,¹⁶ and SBC refers to it as “meaningless.”¹⁷ The Declaration of SBC witness David Toti purports to identify the myriad problems inherent in the separations results codified in the ARMIS system and is representative of the arguments found in all of the BOCs’ comments.

Mr. Toti repeats the same broadbrush criticism of ARMIS that SBC and the other BOCs have long articulated but substantiates it with a new contention – that the “separations freeze” ordered by the Commission in 2001:

preclude[ed] the Incumbent Local Exchange Carriers (‘ILECs’) from adjusting categorical and jurisdictional factors used to allocate costs across categories of services reported in ARMIS ... [and] rendered the jurisdictional and Part 69 element cost allocations even more unreliable. As a result, rates of return calculated using

¹⁴ Verizon Initial Comments, Declaration of William E. Taylor at para. 18; BellSouth Initial Comments at 13.

¹⁵ BellSouth Initial Comments, at 9.

¹⁶ Verizon Initial Comments at 19. Qwest Initial Comments at 12.

¹⁷ SBC Initial Comments at 6.

ARMIS data, including special access rates of return, would be inherently flawed.”¹⁸

Mr. Toti’s declaration does not offer a clarification or proffer a more accurate estimate of SBC’s rate of return on special access to substitute for the “inherently flawed” 76% figure for 2004 reported in ARMIS. Indeed, his declaration offers no substantive analysis or facts and appears to be based on assumptions that are either entirely unsupported and undocumented, or entirely wrong.

For example, nowhere does Mr. Toti actually assert that the 2001 “separations freeze” has definitively affected the calculated rate of return on SBC interstate special access services. Instead, all of his contentions are phrased as mere speculations:

- “... The *likely result* is a continually worsening mismatch between costs and revenues on a jurisdictional, access element basis, ...”¹⁹
- “... The allocation results obtained under Parts 36 and 69 *very likely* do not accurately reflect this upsurge, because the percentages used to assign costs jurisdictionally and categorically were frozen as a result of the FCC’s *Separations Freeze Order*. ...”²⁰
- “... there is *a substantial likelihood* that the freeze produces ARMIS results that understate the costs an ILEC incurs to provide any service that has experienced significant growth in volumes. ...”²¹
- “... ARMIS reporting trends from 1995 through 2004 *support a conclusion* that the 2001 Freeze resulted in (or worsened) a mismatch between special access revenues and costs resulting from the Part 36/Part 69 allocation process. ...”²²

¹⁸ SBC Initial Comments, Declaration of David Toti at para. 3, *citing Jurisdictional Separations and Referral to the Federal-State Joint Board*, 16 FCC Rcd 11431 (2001) (“*Separations Freeze Order*”).

¹⁹ *Id.* at para. 17, emphasis added.

²⁰ *Id.* at para. 42, emphasis added.

²¹ *Id.* at para. 4, emphasis added.

²² *Id.* at para. 21, emphasis added.

- “... This plant investment data *strongly suggests* that, by locking in Part 36 categorical and jurisdictional allocators, the Freeze prevented the natural and proportionate growth of cost allocations to elements (such as interstate special access) that were experiencing significant growth in volumes and revenues. ...”²³

Mr. Toti offers no proof that any of these speculations are actually occurring, nor has he identified and evaluated any alternative “explanations” for the “trends” that he purports to have identified.

Even if there were *some* linkage between the “separations freeze” and the escalating returns on interstate special access, there is certainly nothing to suggest – and certainly nothing offered by Mr. Toti to suggest – that the freeze alone would account for the gulf between SBC’s reported 76% rate of return and something much closer to an 11.25% “competitive” rate of return. Indeed, in 2000, the last full year prior to the separations freeze, SBC’s reported rate of return on special access was 41.37% – supracompetitive earnings by any measure which can hardly be blamed on the jurisdictional freeze.

A closer examination of Mr. Toti’s speculations reveals that they are baseless and inapplicable to the special access category in particular, for several reasons. First and foremost, the “separations freeze” applied only to those plant categories and associated expenses that are “allocated” to the state and interstate jurisdictions based on usage-sensitive regulatory factors rather than being *directly assigned* in accordance with customer certification of jurisdictional use. Allocation factors are used primarily for Plain Old Telephone Service (“POTS”) and switched services (including switched access). In the case of

²³ *Id.* at para. 24, emphasis added.

special access, however, a substantial portion of the costs associated with the service are directly assigned and thus have not been affected or distorted by the separations freeze.²⁴

Second, a “freeze” in the factors for allocating costs between the interstate and intrastate jurisdictions would distort the relationship between special access revenues and costs only to the extent that the jurisdictional mix of the physical units of interstate and intrastate special access services purchased by customers has changed, not revenues. Mr. Toti has offered no evidence that it has changed, and *a priori* there is no particular reason to expect that it has.

Finally, all of the various “relationships” that Mr. Toti purports to have examined, in order to find what he describes as a “mismatch” between ARMIS costs and revenues, are based on interstate special access revenues. This fatal flaw in Mr. Toti’s “analysis” begs the fundamental issue in this *NPRM*—specifically, the legitimacy of special access rate increases. According to Mr. Toti, special access revenues are growing faster than special access costs as a result of the “separations freeze.” Remarkably, Mr. Toti doesn’t even mention, much less analyze, the other obvious explanation for revenues that outstrip costs at an unprecedented clip – and the situation that prompted this proceeding in the

²⁴ *Separations Freeze Order*, note 18, *supra*, at para. 23 (“Categories or portions of categories that have been directly assigned in the past, however, will continue to be directly assigned to each jurisdiction. In other words, the frozen factors shall not have an effect on the direct assignment of costs for categories, or portions of categories, that are directly assigned. Since those portions of facilities that are utilized exclusively for services within the state or interstate jurisdiction are readily identifiable, we believe that the continuation of direct assignment of costs will not be a burden on carriers, nor will it adversely impact the stability of separations results throughout the freeze”). Emphasis added.

first place – namely, that the BOCs are using their “special access pricing flexibility” to increase special access prices to supracompetitive levels.

Indeed, the only situation in which the kind of “analysis” offered by Mr. Toti would have any merit is one in which special access *rates* are constrained either by rate of return regulation or an effective form of price cap regulation that closely maps annual price cap rate adjustments to industry productivity trends for the services involved. These conditions do not apply in the case of interstate special access services.

Special access pricing flexibility began almost concurrently with the separations freeze that took effect as of July 2001. As Ad Hoc, AT&T, MCI and numerous other parties have demonstrated in their comments in this docket and on numerous earlier occasions,²⁵ the BOCs used their pricing flexibility to either begin escalating special access rates or maintain them at pre-pricing flexibility

²⁵ See, e.g., Comments of Ad Hoc Telecommunications Users Committee (Jan. 22, 2002) at 2-3, *Performance Measurements and Standards for Interstate Special Access Services*, CC Docket Nos. 01-321, 00-51, 98-147, 96-98, 98-141, 96-149, 00-229, Notice of Proposed Rulemaking, 16 FCC Rcd 20896 (2001) (“*Special Access Performance Standards Rulemaking*”); Comments of Ad Hoc Telecommunications Users Committee (Mar. 1, 2002) at 14-17, *Review of Regulatory Requirements for Incumbent LEC Broadband Services; SBC Petition for Expedited Ruling That It Is Non-Dominant in its Provision of Advanced Services and for Forbearance From Dominant Carrier Regulation of These Services*, CC Docket No. 01-337, Notice of Proposed Rulemaking, 16 FCC Rcd 22745 (2001) (“*Broadband Regulation Rulemaking*”); Reply Comments of Ad Hoc Telecommunications Users Committee (Jul. 1, 2002) at i, *Appropriate Framework for Broadband Access to the Internet Over Wireline Facilities*, CC Docket Nos. 02-33, 95-20, and 98-10, Notice of Proposed Rulemaking, 17 FCC Rcd 3019 (2002) (“*Broadband Wireline Internet Access Rulemaking*”); Comments of Ad Hoc Telecommunications Users Committee (Dec. 2, 2002) at 5, *AT&T Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, RM No. 10593, 17 FCC Rcd 21530 (2002) (“*AT&T Special Access Petition*”); Comments of Ad Hoc Telecommunications Users Committee (Jun. 30, 2003) at 6, *Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements*, WC Docket No. 02-112, and *2000 Biennial Regulatory Review Separate Affiliate Requirements of Section 64.1903 of the Commission’s Rules*, CC Docket No. 00-175, Further Notice of Proposed Rulemaking, 18 FCC Rcd 10914 (2003) (“*ILEC Broadband Dom/Non-Dom Rulemaking*”). See also “*Competition in Access Markets: Reality or Illusion. A Proposal for Regulating Uncertain Markets*,” Economics and Technology, Inc. (August 2004) (“*ETI White Paper*”), filed in the dockets cited above.

levels, rather than implementing the annual, GDP-PI-6.5% rate adjustments that continued to apply in those geographic areas not subject to pricing flexibility. Mr. Toti's entirely unremarkable conclusion that special access revenues have been increasing at a faster rate than special access costs is entirely consistent with the effects of premature pricing flexibility, which Ad Hoc, AT&T, and many others have raised for several years, and has nothing whatsoever to do with the "separations freeze." Indeed, the freeze is a classic red herring that only obfuscates the undeniable fact that the BOCs have exploited their monopoly on special access by escalating prices to huge multiples of cost.

Like the claims about the impact of the separations "freeze," claims that ARMIS results are meaningless because of a mismatch between DSL revenues and costs in the ARMIS special access categories are equally spurious.

As Dr. William Fitzsimmons articulated this claim in his declaration on behalf of Qwest, "the growth of DSL service highlights the problems with the separations data for analyzing financial returns from special access ARMIS data."²⁶ According to Dr. Fitzsimmons (and other commenters who make this argument²⁷), DSL revenues are interstate and therefore booked to the interstate special access revenue accounts. But only "a portion" of DSL-related investments and expenses "flow" to the interstate special access accounts.²⁸ Dr. Fitzsimmons then refers to a graphical representation of "rapidly" growing DSL

²⁶ Qwest Initial Comments, Declaration of Dr. William Fitzsimmons at 2.

²⁷ Verizon Initial Comments, Declaration of William E. Taylor at para. 18; BellSouth Initial Comments at 13.

²⁸ Notably, Qwest failed to document this "portion."

lines nationwide, suggesting by inference that this represents a problem that is only getting worse. Finally, Dr. Fitzsimmons reports that Qwest has approximately one-million DSL customers, that Qwest earned approximately \$220-million in DSL revenues in 2004, and that Qwest estimates it has made approximately \$240-million in investment in the digital subscribers line multiplexors (“DSLAMs”) required to equip a subscriber line with DSL technology.²⁹

There are a number of fatal flaws in Dr. Fitzsimmons’ analysis. First, Fitzsimmons’ declaration is silent on whether the \$240-million in DSLAM investment was entirely and specifically for use in provisioning the regulated DSL services provided through the interstate special access tariffs. If it was, Qwest should have (and perhaps did) directly assign 100% of that investment to the special access category, since direct assignment is unaffected by the “allocation freeze.” If some of the DSLAM investment was used for other purposes, then the \$240-million referenced by Dr. Fitzsimmons has no relevance here at all.

More importantly, it is simply not the case that all DSL-related revenues are included in the interstate special access category. Some DSL services are provided as “line sharing” UNEs and some are provided to end users as part of Internet service bundles. Only the dollars associated with a BOC’s regulated special access services should be included in the interstate special access category, not reciprocal compensation revenues or revenues from the provision by ISP affiliates of Internet access which uses access services as an input. If Dr.

²⁹ Qwest Initial Comments, Declaration of Dr. William Fitzsimmons at 2 – 3.

Fitzsimmons' DSL revenue figure includes all Qwest DSL-related revenue, then it overstates the magnitude of the problem.

The same is true of his estimate of \$240-million in DSL investment. First, as with the discussion of revenues above, only some, but not all of that DSL investment may belong in special access. Second, some of this (undocumented) \$240-million in DSLAM investment will in fact have made its way into the interstate special access investment reported in ARMIS. Dr. Fitzsimmons provides no data that would allow parties or the Commission to evaluate whether too much DSLAM investment, too little DSLAM investment, or just the right amount of DSLAM investment has been allocated to ARMIS. In other words, Dr. Fitzsimmons offers no evidence or analysis to indicate whether the existing allocation of DSL investment to the special access category in ARMIS results in an *over*allocation of DSLAM investment that suppresses what would otherwise be even higher earnings.

Even taking Dr. Fitzsimmons' DSLAM revenue and investment statements at face value, he has failed to demonstrate that the inclusion of 100% of the revenues and exclusion of the investment is somehow "responsible" for the record-setting levels of Qwest special access category earnings (76.8% for 2004). Table 1 below provides the results of a simple check on Fitzsimmons' claims. As the Table demonstrates, even if 100% of the reported DSL revenues are removed from the Special Access category (an adjustment that is extreme in light of the fact that some portion of the DSL revenues should have been booked to special access to begin with, and some DSL investment and expense will

remain), Qwest's interstate special access earnings for 2004 would still be an astronomical 60.3%. Likewise, to take the opposite approach, adding an additional \$240-million in investment to the TPIS category to reflect 100% of Fitzsimmons' reported DSL investment (once again, an extreme calculation since an unknown "portion" of that \$240-million is already in Qwest's special access accounts), Table 1 demonstrates that Qwest's interstate earnings would be 60.2% for 2004 – still at historically unprecedented levels and certainly high enough to demonstrate monopoly profit-taking from special access services by Qwest.

The similar claims of other parties (supported with similarly undocumented or entirely absent data regarding actual DSL revenues, investments, costs, and present ARMIS assignment/allocation levels) must be dismissed for the same reasons by this Commission.³⁰

³⁰ Verizon Initial Comments, Declaration of William E. Taylor at para. 18; BellSouth Initial Comments at 13.

Table 1

Even after making adjustments to ARMIS data for Qwest reported DSL revenues and investments,
Special Access Earnings for 2004 exceed 60%

Row Title	Y2004 Special Access AS REPORTED	Y2004 Special Access DSL Revenues Removed (1)	Y2004 Special Access DSL Investment Added (2)
	(s)	(s)	(s)
Total Operating Revenues	1,690,814	1,470,814	1,690,814
Total Operating Expenses	558,515	558,515	558,515
Other Operating Income/Losses	327	327	327
Total Non-operating Items (Exp)	-793	-793	-793
State Income Taxes	96,446	96,446	96,446
State Other Taxes	18,198	18,198	18,198
Federal Taxes	338,738	265,428	338,738
Calculated Ave. State Tax Rate	8.5%	10.6%	8.5%
Marginal Federal Income Tax Rate	35.0%	35.0%	35.0%
Calculated Net Return	680,037	533,347	680,037
Total Plant In-Service	3,621,864	3,621,864	3,861,864
Total Other Investments	65,712	65,712	65,712
Total Reserves	2,802,587	2,802,587	2,802,587
Calculated Net Investment	884,989	884,989	1,124,989
Average Net Investment per ARMIS	884,989	884,989	884,989
Net Return	680,037	680,037	680,037
Rate of return, calculated	76.8%	60.3%	60.4%

(1) Removed \$220-million in DSL revenues reported in Qwest exhibit of Dr. William Fitzsimmons

(2) Added \$240-million in DSL investment reported in Qwest exhibit of Dr. William Fitzsimmons

(3) Added \$240-million in DSL investment reported in Qwest exhibit of Dr. William Fitzsimmons, and increased operating expenses proportionately by \$37-million.

III. An “X” Factor Is Necessary for Reasonable Special Access Rates

The current special access “X” factor is set equal to inflation, a situation that was originally specified to last for the final year of the CALLS plan, but that continues forward now as a result of the expiration of that plan with no replacement. Consistent with their perverse refusal to recognize objective reality when it comes to the level of competition in this market, the BOCs’ and their experts argue, incorrectly, that the Commission need not adopt a higher “X” factor:

- Verizon claims that “there is no basis upon which the Commission possibly could make such a finding, given the tremendous competition in the provision of special access services and the compelling evidence of declining rates.”³¹
- Qwest argues that the “X” factor should be lowered to “0” claiming that its data “shows” that it “is realizing productivity gains that are no higher than the economy as a whole.”³²
- SBC maintains that the Commission should not impose any “X,” that “there is no reliable basis for concluding that a productivity adjustment is or will be warranted for the ILECs’ special access services”, and that “there is no basis to assume that the ILECs are or will be more productive than the economy as a whole.”³³
- BellSouth maintains that no price regulation is necessary for the special access market at all. Its proposal goes beyond setting the “X” equal to zero – it would eliminate the price cap regulatory paradigm altogether. According to BellSouth, “it is clear that competition for special access services is substantial and increasing. Because the

³¹ Verizon Initial Comments at 42.

³² Qwest Initial Comments at 6. Note that neither Qwest nor its declarant Dr. William Fitzsimmons have provided any data that “shows” anything about Qwest productivity on its own or vis-à-vis the “economy as a whole.”

³³ SBC Initial Comments at 40.

current level of competition is more than adequate to constrain prices, there is no need for placing the restrictive pricing controls upon LECs contemplated in the *NPRM*.”³⁴

Yet in none of these cases do the BOCs present any empirical evidence to support their positions. There is no evidence in the record to support retention of the existing “X” set equal to inflation, or for an “X” set equal to zero. In lieu of introducing factual evidence, the BOCs rely on conclusory and unsupported allegations. Statements like Qwest’s – that “the X-factor has not reflected the actual productivity of Qwest for some time and it needs to be re-oriented” or that “Qwest has experienced a decline in its overall revenue, and has not realized productivity gains greater than the economy as a whole for the last few years”³⁵ – provide the Commission with no basis for agreeing with the BOCs. Instead of providing affirmative evidence documenting and supporting the position they have taken regarding a static or reduced X-factor, the BOCs’ have relied exclusively on unsupported arm-waving about potential and unmeasured problems with the Commission’s ARMIS data.

The Commission must not lose sight of the fact that the BOCs themselves are the keepers of the data relative to their own productivity. Thus, the failure of all four to provide any quantitative data or analysis to support their X-factor proposals must be read as an indication that no empirical analysis would support their proposed results.

Conversely, the record in this proceeding is rich with data demonstrating the need for a new, higher X. As Ad Hoc documented in its initial comments, the

³⁴ BellSouth Initial Comments at 59.

³⁵ Qwest Initial Comments at 9.

average returns for the special access category across the four BOCs was 53.7% in 2004.³⁶ Figure 4 in Ad Hoc's filing documented the steady increase, year after year, in the level of special access returns.³⁷ The steadily increasing return levels began in the late 1990s, when the X-factor applicable to all interstate access services was set at a maximum level of 5.3%, and continued to escalate following adoption of the 6.5% X-Factor. Steadily increasing prices and return levels, beyond anything that could be sustained in a well-functioning market for a period approaching 10-years and in the face of 5.3% and 6.5% annual X-factor price adjustments, constitute, on their own, prima facia evidence that the previous X-factor levels were too low, at least as they related to the productivity experienced in the provision of special access services.

Corroborating that evidence are the results of the two X-factor studies undertaken by Ad Hoc's economic consultants, Economics and Technology, Inc., and documented in the attached Declaration of Susan M. Gately, Senior Vice President at ETI.³⁸ Ms. Gately's Declaration contains the results of both an "implicit X" study for interstate special access services, and a TFP-based study of special access productivity, as well as documentation of all of the data necessary to evaluate and replicate those studies. In both cases, the results of those studies produced an X in the range of 10%. Specifically, the "implicit X" study yielded an "X" of 10.71%, while the TFP study produced an X of 11.01%.

³⁶ Ad Hoc Initial Comments at 45. This same data was reported by other non-BOC commentors as well.

³⁷ Ad Hoc Initial Comments at 32.

³⁸ See Gately Reply Declaration at 4-8. The 11.01% X from the TFP study is the result of a combined Total Factor Productivity Differential of 13.64% and an input price differential of -2.63%.

On this record, and in the wake of the BOCs shockingly high prices and returns for special access services, “[t]he Commission should, indeed must, reimpose a productivity-based X-Factor for special access services.”³⁹

IV. A Reliable “X” Factor Specific to Special Access Can Be, And Has Been, Developed

Contrary to the assertions of Qwest, SBC and Verizon,⁴⁰ it is possible to develop a reliable X-factor for the interstate special access basket in isolation from the remaining interstate access services. As discussed above, Ad Hoc’s economic consultants have, in fact, done exactly that.⁴¹

Waiving the “flawed ARMIS” flag once again, Qwest, SBC and Verizon maintain that the nature of the telecommunications infrastructure and accounting practices make the identification of a productivity estimate for a single category of services all but impossible. Words like “difficult” and “hard” are sprinkled through these discussions – suggesting that the mere fact that identification of an interstate special access-only productivity factor will require some work is reason enough to give up the entire process.⁴² But protecting customers from unjust and unreasonable rates, as well as the prohibition in the Communications Act against implicit subsidies, require that the Commission undertake this task to ensure that

³⁹ Ad Hoc Initial Comments at 44.

⁴⁰ SBC Initial Comments at 43-45.

⁴¹ See Gately Reply Declaration at 4-8.

⁴² SBC Initial Comments at 43, Verizon Initial Comments at 42-43, Qwest Initial Comments at 9.

special access customers pay no more than a reasonable rate for the services they obtain.⁴³

V. BOC Claims that Reinitialization Would Dampen Efficiency Incentives Are Misplaced

Throughout the American, indeed the global, economy, corporations in competitive markets are constantly driven to undertake efforts to improve productivity. Typically, any productivity enhancements a firm achieves produces only short-lived improvements in overall profitability until competitors catch up. Yet firms in competitive markets nevertheless pursue cost reductions and efficiency enhancements constantly in order to prevail against competitive pressures. The fruits of any productivity enhancements might flow through to consumers immediately as the corporation attempts to gain (or maintain) market share from its competitors by offering service at a lower price. Alternatively, over time and as competing providers of comparable goods and services mimic those efficiency enhancements (or adopt others), any extraordinary profit levels initially generated by those efficiency enhancements are eliminated as prices are forced by competitive market dynamics to make their inevitable march towards costs.

By opposing proposals to “re-initialize” special access rates, the BOCs apparently would have this Commission believe that firms have no incentive to strive towards efficiency in the production of their services absent the ability to

⁴³ See Section 254(e) of the Act, 47 U.S.C. § 254(e).

retain all of the gains from productivity enhancements, *forever*.⁴⁴ Verizon, for example, maintains that re-initializing rates “would punish price caps LECs for acting on the very incentives that price caps regulation was intended to create. Price caps regulation is supposed to reward carriers with higher returns if they are able to increase efficiencies....”⁴⁵

These arguments are, on their face, ridiculous with respect to the one-time re-initialization contemplated in the *NPRM*. It has been more than a decade since the FCC has implemented any kind of re-initialization of price cap-regulated price levels. The BOCs have been “rewarded” for any increased efficiencies for a period far longer than that sustainable in a competitive market, while purchasers of special access services have been denied the benefits of any lower cost structures that may have evolved as a result of those efficiencies. In real competitive markets, corporations do not get to keep all of the additional profitability flowing from efficiency enhancements *forever*. There is no reason for the BOCs to be insulated from those same pressures. If the competitive conditions in the market are not sufficient to ensure that the benefits of efficiency improvements eventually flow through to consumers in the form of lower prices, then regulators must step up to the plate and act as a surrogate for those missing market forces.

⁴⁴ See, e.g., SBC Initial Comments at 37, and Declaration of Joseph P. Kalt at para. 70, claiming that re-initialization would cause providers to “lose incentives to cut costs and innovate in the market”; Verizon Initial Comments at 41.

⁴⁵ Verizon Initial Comments at 41.

CONCLUSION

In view of the foregoing, the Ad Hoc Telecommunications Users Committee urges the Commission to adopt the recommendations found in our initial comments in this proceeding.

Respectfully submitted,

AD HOC TELECOMMUNICATIONS
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CERTIFICATE OF SERVICE

I, Michaeleen I. Terrana, hereby certify that true and correct copies of the preceding Reply Comments of Ad Hoc Telecommunications Users Committee were served this 29th day of July, 2005 via the FCC's ECFS system with a copy to Best Copy and Printing, Inc.

A handwritten signature in black ink, appearing to read "Mil. Terrana", written in a cursive style.

Michaeleen I. Terrana
Legal Assistant

July 29, 2005