

**Before the
Federal Communications Commission
Washington, DC 20554**

In the Matter of)	
)	
Petition of AT&T Inc. for Forbearance)	WC Docket No. 07-21
Under 47 U.S.C. § 160(c) from)	
Enforcement of Certain of the)	
Commission's Cost Assignment Rules)	
)	

Opposition of the AdHoc Telecommunications Users Committee

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SUMMARY

AT&T has not justified Commission forbearance from enforcement of the cost assignment and allocation rules identified in its petition for forbearance. Contrary to AT&T's claims, costs are still a necessary regulatory tool under price caps regulation. The various formulae and indices in the FCC's system of price caps regulation were not intended to and did not establish rate levels that necessarily qualify as "just and reasonable" or non-discriminatory under Sections 201, 202, and 10(c) of the Communications Act. Information regarding carrier costs remains necessary to make those determinations regarding a carrier's rates, even a price caps carrier's rates.

Moreover, price caps carriers such as AT&T are permitted by the rules to propose rates above price cap ceilings. They may also urge the Commission to change price caps limits or seek permission to price below price cap floors. In those instances, cost information developed pursuant to the Commission's cost assignment and allocation rules would be necessary to determine whether the carriers' requests should be granted.

Without cost information, consumers of AT&T's interstate services would be unable to show in complaint proceedings that AT&T's rates were excessive. Earnings are also relevant to determining whether price caps rules are properly specified. Without data regarding costs, revenues, and earnings, the Commission would be unable to verify carrier claims that their earnings are deficient and that the rules pursuant to which price cap indices are set should be

modified. Similarly, the Commission could not reasonably evaluate customer challenges to the price cap indices based on supra-competitive carrier earnings.

Without cost information, AT&T and other price cap local exchange carriers would soon argue that the pending special access rate investigation in WC Docket No. 05-25 is meaningless and should be terminated. Without cost information, the Commission would be unable to satisfy its obligation to ensure that those special access rates and other rates subject to its jurisdiction are just and reasonable. Without cost information, the Commission would be without important information about the level of competition in telecommunications markets and the degree of regulation appropriate for those markets. In short, although AT&T may wish that the Commission were without cost information and that rhetoric would suffice as a justification for eliminating it, such information is critical to determining the justness and reasonableness of rates and protecting consumers from exploitive rates.

AdHoc's opposition to AT&T's petition does not require a return to rate base/rate-of-return regulation. AdHoc opposes AT&T's petition even though AdHoc is a proponent of price caps regulation. Contrary to AT&T's suggestion, the Commission has never found that incentive regulation pursuant to price caps severs all links to the carriers' underlying costs. Price caps allows carriers to avoid detailed tariff filing justifications if they price within the limits set by the price caps indices. But the price caps indices are just a tariff filing tool, not the measure of just and reasonable rates for purposes of formal complaints or rate

prescriptions. For those purposes, the Commission must retain the cost accounting rules AT&T seeks to avoid.

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**OPPOSITION OF THE ADHOC TELECOMMUNICATIONS USERS
COMMITTEE**

Pursuant to the Commission's February 16, 2007 Public Notice¹ in the docket captioned above, the AdHoc Telecommunications Users Committee ("AdHoc")² hereby submits its Opposition to the petition filed by AT&T Inc. ("AT&T").

INTRODUCTION

The instant petition seeks substantially the same relief, supported by substantially the same arguments and assertions, as that sought by what is now

¹ *Pleading Cycle Established for AT&T Inc. Petition for Forbearance from the Commission's Cost Assignment Rules*, WC Docket No. 07-21, Public Notice, DA No. 07-731 (rel. Feb. 16, 2007).

² AdHoc is an unincorporated association that represents its members' interests in telecommunication matters pending before the FCC and the courts. Its members are among the nation's largest and most sophisticated corporate buyers of telecommunications services and products. Seventeen of AdHoc's twenty members are Fortune 500 companies, including eight of the Fortune 100. They estimate their combined spend on communications products and services at between two and three billion dollars per year. AdHoc admits no carriers as members and accepts no carrier funding. AdHoc's self-interest is served by avoiding the imposition of unnecessary regulatory constraints on incumbent service providers, such as AT&T. In an effectively competitive market, AdHoc's members do not need regulation to protect their interests and would not advocate it.

AT&T's affiliate, BellSouth Telecommunications, Inc. ("BellSouth") in the petition BellSouth filed with the Commission on December 6, 2005 and subsequently withdrew and re-submitted on February 9, 2007 in WC Docket No. 05-342.

Because the two petitions share the same fundamental flaws in fact and logic, AdHoc opposes AT&T's forbearance petition for substantially the same reasons, discussed below, as those set forth in AdHoc's Opposition and Reply Comments on BellSouth's petition in WC Dkt. No. 05-342.

I. STANDARD FOR EVALUATING FORBEARANCE PETITIONS

Unless prohibited by other sections of the Act, Section 10 of the Communications Act, 47 U.S.C. §160, directs the Commission to forbear from enforcement of statutory provisions and regulations if, and only if, it determines that

(1) enforcement of such regulation or provision is not necessary to ensure that the charges, practices, classifications, or regulations ... are just and reasonable and are not unjustly or unreasonable discriminatory; (2) enforcement of such regulation or provision is not necessary for the protection of consumers; and (3) forbearance from applying such provision or regulation is consistent with the public interest.

Section 10 requires AT&T to demonstrate persuasively that all elements of the forbearance test have been met so that the Commission can determine that forbearance is justified. AT&T has not come close to satisfying the forbearance standard and the Commission cannot find otherwise.

II. THE COMMISSION'S SPECIAL ACCESS INVESTIGATION CONFIRMS THE CONTINUING NEED FOR COST ACCOUNTING RULES

The Commission has initiated a rulemaking to determine whether its special access pricing flexibility rules have worked as intended and if not,

whether they should be modified or repealed.³ In that proceeding, AdHoc demonstrated, based in part on the incumbent local exchange carriers' ("ILECs'") astronomical prices for and profits from their special access services, that the special access market is not sufficiently competitive to discipline ILEC prices and that repeal of the special access pricing flexibility rules is long overdue.

Granting AT&T's petition would render the ongoing special access rulemaking meaningless. If the Commission grants AT&T's petition, forbearance petitions from other Bell Operating Companies ("BOCs") would inevitably follow. Given the Commission's apparent decision to treat the special access rulemaking with no sense of urgency, it takes little experience or sophistication to recognize that within a year after grant of AT&T's petition, AT&T will argue that the record in the special access investigation is stale. And if the existing cost information in that docket is stale, AT&T can be expected to argue that no one, not even the Commission, can know whether its special access rates are excessive in relationship to the cost of providing special access service because special access costs would not be determinable.

If its petition were granted, AT&T would be free to intermingle regulated services costs and unregulated services costs. The jurisdictional character of costs would also be indiscernible, and the allocation of common costs among services would be irrelevant, making a reasonable assessment of special access service costs unduly burdensome if not impossible. Surely the Commission will

³ *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*, WC Docket No. 05-25, RM-10593, Order and Notice of Proposed Rulemaking, 20 FCC Rcd 1994 (2005) ("*Special Access Rulemaking*" or "*Special Access NPRM*").

conclude that it cannot grant AT&T's petition given the pendency of the special access rulemaking. Surely the Commission will not respond to astronomical rates of return on special access – 91.7% for 2005 in AT&T's case⁴ – by eliminating the data needed to calculate those returns instead of revising its regulatory regime to protect consumers from excessive rates.

In the *Special Access NPRM*, the Commission asked that parties identify, justify, and explain an objective benchmark against which to measure the carriers' most recent rate level data.⁵ AdHoc explained in its comments that, in addition to evidence regarding the actual prices charged by the ILECs, an appropriate method for measuring whether the Commission's predictions regarding special access competition were correct is an evaluation of the ILECs' earnings for the special access category. Earnings, of course, cannot be determined without reference to underlying costs.

AdHoc does not maintain that any price that results in a rate of return in excess of the Commission's last-approved rate of return of 11.25%⁶ is automatically "unjust" or "unreasonable." But the substantial and sustained growth in special access earnings levels that has occurred since the pricing flexibility rules were implemented is indicative of a market in which service provider prices are not being disciplined by competitive forces. RBOC special

⁴ See Attachment B to Reply Comments of AdHoc (filed Jun. 20, 2006) ("*Gately Declaration*") in *AT&T Inc. and BellSouth Corp. Applications for Approval of Transfer of Control*, WC Docket No. 06-74 ("*AT&T/BellSouth Merger Proceeding*") at para. 10.

⁵ *Special Access NPRM* at para. 74.

⁶ *Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers*, CC Docket No. 89-624, *Order*, 5 FCC Rcd 7507 (1990) at para. 1 ("*Represcribing Order*").

access returns ranged between 4.0% and 16.0% in 1996.⁷ AdHoc's Reply Comments in the *AT&T/BellSouth Merger Proceeding* used the Commission's more recent data to show that the "average" BOC return on special access services has grown from a more than healthy average of 31.6% in 2000 to a whopping 67.8% in 2005.⁸ Returns at these levels simply could not be sustained over a multi-year period in a mature market subject to competition.

The Commission's statutory obligations under section 201(b) of the Act require the agency to stop carriers from using their market power to gouge consumers of special access services. Surely the Commission would not attempt to resolve cases of price-gouging by eliminating the evidentiary basis on which such claims rest.

The ILECs' primary response to evidence of the extraordinarily high level of profits on special access services was not to assert that earnings are irrelevant to whether rates are just and reasonable but to claim instead that the regulatory accounting data found in the Commission's ARMIS reports could not be credibly used for ratemaking purposes.⁹ AdHoc demonstrated, however, that the ILEC criticism of earnings results based on ARMIS data is at best disingenuous.

⁷ See Attachment A to Comments of AdHoc (filed June 13, 2005) in the *Special Access Rulemaking*, "Competition in Access Markets: Reality or Illusion. A Proposal for Regulating Uncertain Markets," Economics and Technology, Inc. (August 2004) ("*ETI White Paper*"), as amended by Attachment B to the same filing, Declaration of Susan M. Gately (June 13, 2005) at 54.

⁸ *Gately Declaration*, note 4, *supra*, at para. 10.

⁹ The ILECs' claims in this area can be found throughout the comment cycles in response to *AT&T's Special Access Petition* to re-regulate special access services (RM-10593) and in response to AT&T's Petition for Writ of Mandamus relative to that proceeding. See *AT&T Corp. Petition for Rulemaking To Reform Regulation of Incumbent Local Exchange Carrier Rates For Interstate Special Access Services*, RM-10593 ("*AT&T Special Access Petition*"), Opposition of Qwest Communications, filed December 2, 2002, at pp. 8-13; Opposition of SBC Communications, filed December 2, 2002, at pp. 19-22; Comments of BellSouth, filed December

First, the ILECs themselves rely on ARMIS in other venues and emphasize its value and utility. Unlike their challenges to ARMIS before this Commission – when ARMIS results reveal excessive earnings – the ILECs have argued *in favor* of using ARMIS when ARMIS results suggest an earnings deficiency or “below cost” pricing.¹⁰ The ILECs’ claims that ARMIS-based rates

2, 2002, at pp. 4-6; Opposition of Verizon, filed December 2, 2002, at pp. 21-23. In addition, BellSouth and Qwest suggested that the inclusion of DSL revenues in the Special Access Revenue category skewed results. In a declaration by Dr. Lee Selwyn, attached to AT&T’s reply comments, Selwyn calculated that adjusting for DSL revenues would only reduce overall return rates by a couple of percentage points. *See* Reply Declaration of Lee L. Selwyn, Reply Comments of AT&T, filed January 23, 2003, at pp. 46-58, in *AT&T Special Access Petition*.

¹⁰ For example, in May 2003 in Federal District Court in Chicago, Illinois, just five months after challenging the use of ARMIS data to evaluate the reasonableness of special access prices in response to the *AT&T Special Access Petition*, SBC relied specifically upon ARMIS results to support its contention that UNE rates were not covering their costs. According to SBC’s expert witness:

SBC Illinois’ average revenue per loop (for UNE-L) and revenue per line (for UNE-P) per month is substantially below the costs that SBC Illinois recognizes on its books to provide those UNEs. I used the FCC’s financial accounting information as reported in its Automated Reporting Management Information System (“ARMIS”) files to obtain the historical cost data specifically for SBC Illinois. These data are reported to the FCC for purposes of tracking the interstate rate of return and are subject to a highly detailed set of reporting guidelines.

See Affidavit of Debra J. Aron on behalf of SBC in United States District Court for the Northern District of Illinois, Eastern Division, Case No. 03-C3290, filed May 27, 2003.

Several months later, in December 2003, SBC was joined by USTA and other BOCs in lauding ARMIS as the source for the “actual” costs of UNEs in the response to the FCC’s *TELRIC NPRM*. *See, e.g., Review of the Commission’s Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers*, WC Docket No. 03-173, Comments of United States Telecom Association, (filed December 16, 2003), at p. 10; Comments of the Verizon Telephone Companies at pp. 40, 46, 58, 94; Opening Comments of SBC Communications, Exhibit A, “*The Economics of UNE Pricing*,” prepared by Debra J. Aron, PhD and William Rogerson, PhD (filed December 16, 2003), at pp. 28-32.

One month later, in January 2004, SBC and its sister RBOCs argued to the United States Court of Appeals for the District of Columbia Circuit (in opposing AT&T’s Petition for Writ of Mandamus) that “ARMIS data contain arbitrary allocations that are economically irrational.” *See AT&T Corp. et al.*, No. 03-1397 (D.C. Cir.), Response of Intervenor in Opposition to AT&T’s Petition for a Writ of Mandamus, filed January 9, 2004, at 13.

Flip-flopping yet again only two months later, SBC defended the validity of ARMIS as the correct basis for benchmarking UNE costs in testimony filed with the Illinois Commerce Commission on March 5, 2004. SBC’s witness, Dr. Aron, stated,

In the final analysis, ARMIS is no better or worse than any cost accounting system for a large, multiproduct firm. It is subject to strict reporting requirements and a consistent set of rules across carriers. Virtually all cost accounting systems will be subject to the

of return for special access are inflated by the misallocation of costs to other services (*i.e.*, the Common Line category)¹¹ are belied by their simultaneous defense in other proceedings and venues of the accuracy of ARMIS cost allocations to the Common Line category, thus admitting that special access costs are *not* being misallocated to that category.¹²

In other words, to explain away excessive profit levels for special access, the ILECs in the past have asserted that ARMIS understates special access costs by misallocating some of those costs to the Common Line category. But when the shoe is on the other foot, when the ILECs are fighting for higher UNE prices to reflect high Common Line costs, the ILECs staunchly defend ARMIS and the use of ARMIS Common Line data as the basis for UNE-Loop prices, claiming that prices based on ARMIS include only costs actually attributable to

criticism that they make allocations, and to the criticism that any full cost estimate (which, as I noted, includes TELRIC-based UNE prices as well) will reflect such allocations. However, the fact nevertheless remains that accounting systems are the basis for decision making in our economy, and that it is reasonable to look at accounting estimates of costs for benchmarking purposes such as this one.

See Illinois Commerce Commission, Docket No. 02-0864 SBC Illinois Ex. 2.2 (Surrebuttal Testimony of Dr. Debra J. Aron) (*“Illinois - Aron Surrebuttal Testimony”*) filed March 5, 2004, at p. 9.

¹¹ In its Response to AT&T’s Petition for Writ of Mandamus, ILECs (including SBC) claimed that the apparently high rates of return on special access arise because ARMIS rules require that certain special access-related costs be assigned elsewhere. *See 03-1397 BOC Opposition* at 14. In fact, in the interstate jurisdiction, the only other place where these costs *could be* allocated is to the Common Line category.

¹² For example, in a recent UNE proceeding, SBC submitted testimony that claimed that ARMIS costs for the switched access loop are “fairly straightforward” and reliable indicators of the investment and associated expenses specifically associated with that category (and element).” In this context, SBC’s witness stated, “... the costs that ARMIS associates with the loop are fairly straightforward and, except for the shared and common costs of the sort that affect TELRIC costs as well, these costs are reliable indicators of the investment and associated expenses specifically associated with that category (and element). The shared and common costs represent a portion of the costs associated with support assets (and expenses) such as land, buildings, trucks, tools, and personnel, a share of which are appropriately assigned to elements in ARMIS. These costs are also allocated to elements in a TELRIC analysis.” *See Illinois - Aron Surrebuttal Testimony* at p. 9.

switched access loops with none of the special access misallocations they claim in order to explain away their special access overearnings.

In the instant petition, AT&T is trying a different tactic. Instead of arguing that ARMIS data is not reliable, AT&T is urging the FCC to eliminate it. But the Commission cannot reasonably base a forbearance decision on AT&T's irreconcilable and self-serving claims regarding the utility and accuracy of ARMIS rules. While it's true that cutting off the information flow would be an effective way to deal with embarrassingly high rates of return, the Commission's concern must be the public interest and the interests of consumers, not AT&T's corporate self-interest.

Second, the ARMIS financial results simply document the costing and accounting rules that have been implemented by the Commission over several decades. The ILECs themselves have had a larger role in the development of these rules than any other party. Therefore, they can hardly be heard to claim that the rules and reporting requirements do not reflect reality. If the ILECs really believe that the rules produce inaccurate data, they have been free to identify any necessary modifications. Instead, AT&T would have the rules eliminated completely.

Third, whether or not ARMIS data includes minor cost misallocations at the margins does not affect the overall integrity of *trends* in the data, since those alleged misallocations do not change from period to period. In other words, even if the absolute rate of return developed for the special access category using ARMIS data is off by some small percentage, the trend in the data (in this case

steadily *up*) is nevertheless a reliable and probative indicator of the BOCs' ability to increase prices to supracompetitive levels over a multi-year period without fear of attracting competitive entry.

III. FORBEARANCE WOULD BE INCONSISTENT WITH THE STATUTORY REQUIREMENTS IN SECTION 201(b)

Under the Communications Act, the Commission is obligated to ensure that the charges of common carriers for regulated interstate telecommunications services are "just and reasonable."¹³ The courts have recognized that the Commission must "execute and enforce" the provisions of the Communications Act and that it may not abdicate its duty to ensure that statutory standards are met, including the requirement that ILEC rates be "just and reasonable."¹⁴ As the U.S. Court of Appeals for the Second Circuit recognized in *American Telephone & Telegraph Co. v. FCC*,

[t]he Communications Act requires . . . that rates . . . be just, fair, reasonable and nondiscriminatory. . . . We are aware of no authority for the proposition that the FCC may abdicate its responsibility to perform [this duty] and ensure that these statutory standards are met.¹⁵

Section 10 of the Act allows the Commission to forbear from enforcing Section 201 if it can reasonably find that enforcement of section 201 is not necessary to ensure just and reasonable pricing and practices and to protect consumers. But the Commission cannot make such a finding with respect to special access rates

¹³ 47 U.S.C. § 201(b) (rates shall be just and reasonable).

¹⁴ See *MCI Telecommunications Corp. v. FCC*, 765 F.2d 1186, 1192 (D.C. Cir. 1985) (quoting 47 U.S.C. § 151); cf. *Southwestern Bell Telephone Company v. FCC*, 10 F.3d 892, 894 (D.C. Cir. 1993).

¹⁵ *American Telephone & Telegraph Co. v. FCC*, 572 F.2d 17, 25 (2d Cir.), cert. denied, 439 U.S. 875 (1978) (citations omitted).

given the record in the *Special Access Rulemaking* and that presented by AT&T in this proceeding.

The courts have determined that, when Congress requires an agency to set or oversee regulated companies' rates, which is the case with respect to special access rates, the agency must ensure that those rates fall within a "zone of reasonableness."¹⁶ The "zone of reasonableness" encompasses both the minimum and maximum rate levels that an agency may authorize a regulated company to charge. In *Farmers Union Central Exchange v. FERC*, the U.S. Court of Appeals for the D.C. Circuit explained:

When the inquiry is whether the rate is reasonable to a producer, the underlying focus of concern is on the question of whether it is high enough to both maintain the producer's credit and attract capital. . . . When the inquiry is whether a given rate is just and reasonable to the consumer, the underlying concern is whether it is low enough so that exploitation by the [regulated business] is prevented.¹⁷

If this Commission were to forbear from enforcing the cost assignment and allocation rules targeted by AT&T's petition, without a reasonable finding that the interstate access market is effectively competitive (which the Commission cannot make in the case of special access and most switched services), the Commission would foreclose the very inquiry cited by the courts and contravene the Commission's statutory responsibilities.

Moreover, federal courts have consistently reviewed the earnings of regulated companies in addressing claims regarding the reasonableness of

¹⁶ See, e.g., *Permian Basin Area Rate Cases*, 390 U.S. 747, 767 (1968); *United States v. FCC*, 707 F.2d 610, 612 (D.C. Cir. 1983).

¹⁷ *Farmers Union Central Exchange v. FERC*, 734 F.2d 1486, 1502 (D.C. Cir. 1984).

carrier rates.¹⁸ In *Hope Natural Gas*, the Supreme Court held that, at a minimum, a regulated entity's rates must produce sufficient revenues to cover operating expenses and capital costs and yield a return "commensurate with returns on investments in other enterprises having corresponding risks."¹⁹ Similarly, in its more recent decision in *Duquesne Light Co. v. Barasch*, the Supreme Court explained that the reasonableness of a regulated company's rates turns on whether the company is earning a fair return on investment, given the risks the company faces under the ratemaking system to which it is subject.²⁰

The statutory "just and reasonable" standard simply does not permit regulated entities to earn unlimited profits. As the Court explained in *United States v. FCC*, regulated utilities are entitled to earn enough revenue to cover operating expenses and capital costs, but "[t]he return should not be higher than necessary for this purpose . . . because otherwise ratepayers would pay the excessive prices that regulation is intended to prevent."²¹ Thus, even in a price caps regime, the ultimate test of the reasonableness of a rate is not whether the rate is consistent with the price caps showing required at the time it is filed but whether the rate produces revenues far in excess of what is required to cover operating expenses and capital costs.

AdHoc does not dispute that the Commission has broad discretion to craft a regulatory scheme that satisfies the requirement that carriers' charges be just

¹⁸ See, e.g., *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944); *American Telephone and Telegraph Co. v. FCC*, 836 F.2d 1386, 1390 (D.C. Cir. 1988).

¹⁹ *Id.*, 320 U.S. at 603.

²⁰ *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 310 (1989).

²¹ *United States v. FCC*, 707 F.2d at 612 (citations omitted).

and reasonable. Such discretion must, however, be exercised in a manner that produces rates within the zone of reasonableness. Granting AT&T's petition would be utterly incompatible with the Commission's responsibilities under the Act, including section 10 of the Act, since it would eliminate the Commission's ability to determine whether rates are in the zone of reasonableness.

IV. FORBEARANCE WOULD BE INCONSISTENT WITH THIS COMMISSION'S REPRESENTATIONS TO THE COURT OF APPEALS

Grant of AT&T's petition would put the Commission in an indefensible position before the United States Court of Appeals for the District of Columbia. In opposing the former AT&T's petition to the D.C. Circuit for a writ of mandamus ordering the FCC to initiate a rulemaking to vacate its special access pricing flexibility rules and adopt new rules, the Commission, *inter alia*, stated to the Court that special access customers should not be entitled to the requested relief because complaints under section 208 of the Act would be an adequate remedy.²² Such complaints would be impossible if AT&T petition is granted because no relevant cost data would be available and thus earnings could not be calculated using revenue and cost data. Indeed, the *Special Access Rulemaking* itself would be an empty proceeding. The Commission could not credibly reconcile a grant of AT&T's petition with the Commission's statements to the Court and release of the *Special Access NPRM*.

²² Opposition of the Federal Communications Commission To Petition For Writ Of Mandamus, U.S. Court of Appeals for the D.C. Circuit, No. 03-1397, at 26-27. The Court dismissed as moot AT&T's Petition for Writ of Mandamus after the Commission issued the *Special Access NPRM*.

V. AT&T'S PETITION MISCHARACTERIZES THE RELATIONSHIP BETWEEN RATES AND COSTS IN THIS COMMISSION'S PRICE CAPS REGIME

In addition to the relevance of costs to section 201(b) determinations, costs continue to be independently important under the Commission's price cap rules. AT&T's contention that "by adopting price cap regulation, the Commission and the states have eliminated the purpose of the cost assignment rules" is simply wrong.²³ Price cap regulation as prescribed by the Commission does not sever all links between rate-setting and costs.

Price caps, at the federal and state levels, are based on various indices and measurements of productivity. This form of regulation is intended to encourage carrier efficiency and produce results very similar to those that competitive markets would yield. When regulatory authorities, including the Commission, prescribe price caps formulae, that is not the end of regulatory oversight. Regulators continue to evaluate the operation of the system and revise the formulae or indices as necessary. An important measure of the system's efficacy includes carrier earnings. In order to determine whether the formulae were properly specified to begin with and to evaluate the formulae over time as circumstances and industry conditions change, the Commission needs to review carrier earnings. Earnings that are consistently too low or too high indicate the need for revisions to the formulae.²⁴ Without cost assignment and allocation rules, carriers subject to price cap regulation could misallocate costs to

²³ AT&T Petition at 22.

²⁴ AT&T currently must file Form 492A "to enable the Commission to monitor access tariff and price-caps earnings." FCC Form 492A, "General Instructions." AT&T, of course, asks the Commission to forbear from enforcing this requirement.

repress earnings levels and thus (1) avoid formulae adjustments that would result in rate reductions and (2) support formulae adjustments that would yield rate increases.²⁵ Grant of AT&T's petition would create precisely this environment, and would therefore be unjustified under the section 10 forbearance standards.

AT&T's petition relies on a high-level description of price caps systems to argue that costs are no longer relevant to the Commission's regime. But a more detailed understanding of the price caps rules reveals that those rules themselves preserve costs as an element of AT&T's ratemaking and the Commission's evaluation of AT&T's rates. For example, the Commission has explained that price caps carriers' tariff filings that include rate changes below the pricing bands established by the Commission, "[m]ust be accompanied by an *average variable cost showing*..."²⁶ Tariff filings by price caps carriers that include above-band rates "[m]ust be accompanied by a *detailed cost showing* that will enable the Commission to determine compliance with statutory requirements of just and reasonable rates that are not unjustly discriminatory."²⁷

Moreover, under the Commission's price caps rules, all exogenous cost changes set forth in section 61.45(d) of the Commission's rules involve changes in the underlying regulated interstate costs of AT&T and require AT&T to adjust

²⁵ See Kenneth Train, *Optimal Regulation* 327 (1991) (under price cap regulation, a firm will have an incentive to "waste so as to convince the regulator to allow a higher cap"). A Commission-convened Joint Conference on Accounting, which was comprised of members of the FCC and state public utility commissioners, concluded that a dominant local carrier can benefit from cost allocation by "making its regulated earnings appear as low as possible, such as when it is pursuing a takings claim, seeking regulatory relief based on allegedly depressed earnings, or is subject to a profit-sharing requirement. Recommendation by Joint Conference, *Federal-State Joint Conference On Accounting Issues*, WC Docket No. 02-269, at 24 (Oct. 9, 2003).

²⁶ *Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, 5 FCC Rcd 6786, 6789 (1990).

²⁷ *Id.*

its price caps indices to reflect such cost changes. Exogenous costs are not limited to those specified in 61.45(d). The Commission at one point stated that it has “[r]etained the discretion to consider extending exogenous cost treatments to ‘other extraordinary cost changes that the Commission shall permit or require.’”²⁸ AdHoc believes that since the inception of price cap regulation for incumbent LECs in 1991, the BOCs have made exogenous adjustments to their price cap indices every, or virtually every, year.

The foregoing discussion demonstrates that AT&T’s costs are relevant to setting the indices that generally control AT&T’s prices in a price caps environment. AT&T’s claim that costs are irrelevant under current price caps regulation is simply wrong.

Finally, as the Commission is aware, the so-called “CALLS” plan has expired and must be replaced with a permanent plan which could be a form of price cap regulation that uses a productivity offset to calculate price cap indices.²⁹ Historically, costs have been relevant to setting the productivity offset, the “X-Factor,” in the Commission’s price caps rules. Total factor productivity (“TFP”) studies, the method used most recently by the Commission to measure the productivity of local exchange price caps carriers, is the “[r]elationship between the output of goods and services to inputs of basic factors of production

²⁸ *Price Cap Performance Review for Local Exchange Carriers*, 12 FCC Rcd 16642, 16711 (1997) (emphasis added).

²⁹ *Access Charge Reform*, Sixth Report and Order, CC Docket Nos. 96-262 and 94-1, Report and Order, CC Docket No. 99-249, Eleventh Report and Order, CC Docket No. 96-45, 15 FCC Rcd 12962 (released May 31, 2000) (*CALLS Order*).

– capital, labor, and materials.”³⁰ The Commission’s description of the TFP methodology that it used most recently makes clear that costs, including accounting costs, are critical to the methodology.³¹ Determining the costs relevant to TFP studies would be an exercise in futility if AT&T’s petition were granted. Yet the Commission cannot reasonably conclude at this point in time that TFP studies will be irrelevant to regulation of AT&T’s rates in a post-“CALLS” environment.

VI. MARKETPLACE COMPETITION IS INSUFFICIENT TO JUSTIFY THE FORBEARANCE AT&T SEEKS

AT&T’s unsupported assertions that competition eliminates any need for rate regulation – and thus any need for relevant cost data – are also meritless.³² Market forces have proven to be insufficient to control AT&T’s pricing of special access services. Even a cursory review of the record in the *Special Access Rulemaking* rebuts AT&T’s unsubstantiated claims in its petition. AdHoc’s comments in that proceeding reminded the Commission that AT&T’s special access rates of return have been so excessive that they undermine any assertion that the special access market is effectively competitive.³³ Service providers in competitive markets cannot sustain returns as high as AT&T’s have been for the past five years under the Commission’s pricing flexibility rules.

³⁰ *Price Cap Performance Review for Local Exchange Carriers*, 12 FCC Rcd 16642, 16679 (1997); *rev’d and remanded in part, United States Telephone Association v. Federal Communications Commission*, 188 F3d 521 (D.C. Cir. 1999).

³¹ *Id.* at 16679, 16773, 16776-77, 16782.

³² See AT&T Petition at pp. 29-32.

³³ Comments of AdHoc, note 7, *supra*, at 6-7.

But the special access market is not the only access market that lacks effective competition. As the Commission itself has recognized, terminating switched access also is not provided in a competitive market. When a long distance call is terminated or a toll free call is initiated, the long distance carrier who must pay for access service does not select the provider of terminating access. Instead, the end user selects the terminating access provider and may, of course, use a long distance carrier other than the long distance carrier seeking to terminate traffic to that end user.

Because they do not select the terminating carrier they must use, long distance carriers cannot use market alternatives to control their terminating access service costs. In short, there is market failure. Recognizing this market failure, the Commission concluded that it cannot take a hands-off approach with respect to terminating access.³⁴ If the Commission were, however, to grant AT&T's petition, it would, *de facto* and without justification, reverse itself by effectively deregulating interstate terminating access service rates.

Nor can the Commission logically conclude that effective competition exists with respect to originating access service. The Commission initially exercised no regulation of access service rates imposed by competitive local exchange carriers ("CLECs"), believing that the rates charged by the ILECs would constrain CLEC access service rates.³⁵ In the Seventh and Eighth

³⁴ See *Access Charge Reform*, CC Docket No. 96-262, First Report and Order, 12 FCC Rcd 15982, 16135-36 (1997), *aff'd sub. nom. Southwestern Bell v. FCC*, 153 F.3d 523 (8th Cir. 1998).

³⁵ Of course, the Commission has always regulated the interstate access service rates charged by dominant providers of exchange access service.

Reports and Orders in the *Access Charge Reform* proceeding,³⁶ the Commission addressed disputes between long distance carriers and CLECs over the CLECs' access service rates. The Commission basically concluded that the competition which may exist for consumer access lines does not equate to competition for access service. In the *Seventh Report and Order*, the Commission explained that,

although the end user chooses her access provider, she does not pay that provider's access charges. Rather, the access charges are paid by the caller's IXC [long distance service provider], which has little practical means of affecting the caller's choice of access provider (and even less opportunity to affect the called party's choice of provider) and thus cannot easily avoid the expensive ones. ...[T]he Commission has [also] interpreted section 254(g) to require IXCs geographically to average their rates and thereby to spread the cost of both originating and terminating access over all their end users. Consequently, IXCs have little or no ability to create incentives for their customers to choose CLECs with low access charges. Since the IXCs are effectively unable either to pass through access charges to their end users or to create other incentives for end users to choose LECs with low access rates, the party causing the costs – the end user that chooses the high-priced LEC – has no incentive to minimize cost.³⁷

The Commission's own analysis shows that the marketplace cannot provide a check on LEC pricing for interstate access services. Indeed, the Commission to date has never proposed deregulating switched access charges. But deregulation is the relief sought by AT&T in its petition, because without reliable cost data, price caps regulation has extremely limited utility as a mechanism to regulate the access service rates charged by price cap carriers. The market

³⁶ *Access Charge Reform*, CC Docket No. 96-262, Seventh Report and Order, 16 FCC Rcd 9923 (2001); *Access Charge Reform*, CC Docket No. 96-262, Eighth Report and Order, 19 FCC Rcd 9108 (2004).

³⁷ *Id.*, Seventh Report and Order, 16 FCC Rcd at 9935 (para. 31).

failure dynamic that is inherent in the access service market is another reason to deny AT&T's petition.

Finally, the Commission must consider the impact of AT&T's proposal on general reform of intercarrier compensation mechanisms. If AT&T's petition is granted, the Commission will lose access to important cost data that will be relevant to virtually all of the intercarrier compensation reform proposals advanced by parties to the Commission's intercarrier compensation proceeding.³⁸ There is no rational basis for assuming that price caps local exchange carriers should be allowed to recover the same revenues under a reformed intercarrier compensation mechanism as they currently realize. At the very least, that should be an open issue that the Commission should not now prejudge, which is precisely what a grant of AT&T's petition would force the Commission to do.

CONCLUSION

AT&T has failed to establish a record that would enable the Commission

³⁸ See *Developing a Unified Intercarrier Compensation Regime*, CC Docket No. 01-92, Notice of Proposed Rulemaking, 16 FCC Rcd 9610 (2001); Further Notice of Proposed Rulemaking, 20 FCC Rcd 4685 (2005).

to make the findings required by Section 10 of the Act in order to grant the forbearance AT&T seeks. The Commission must therefore deny AT&T's petition.

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Certificate of Service

I, Dorothy R. Nederman, hereby certify that true and correct copies of the preceding Comments of the Ad Hoc Telecommunications Users Committee were filed electronically this 19th day of March, 2007 via the FCC's ECFS system and by email to:

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