

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

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

COMMENTS OF SPRINT NEXTEL CORPORATION

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EXECUTIVE SUMMARY

The special access market is an Economics 101 textbook example of a market failure, and consumers are suffering the consequences of this failure. Special access is the lifeblood of the telecommunications industry, touching virtually every communications product. Every time consumers make wireless calls, access the Internet, send e-mails, swipe their credit cards at mini-markets, or use an automated teller machine (“ATM”), they are using services that rely on special access. Providers of a vast array of telecommunications and information services are, thus, at the mercy of special access provided by the Bell Operating Companies (“BOCs”), who today face no effective competition to the vast majority of their special access lines.

BOC special access revenues have grown from \$2.5 billion in 1990 to a colossal \$15.6 billion in 2006. AT&T and Verizon are by far the largest providers of special access in the United States, accounting for 81% of incumbent local exchange carrier (“LEC”) special access service nationwide in 2006. The danger of AT&T and Verizon’s unchecked market power is clear: AT&T and Verizon have become behemoth, integrated companies, each providing services from virtually every facet of telecommunications and collectively serving millions more customer lines than “Ma Bell” was serving at the time of the break-up in 1984. They provide local and long distance, video, Internet access, and Internet backbone services, and are the largest providers of Commercial Mobile Radio Services (“CMRS”), together accounting for more than 51% of CMRS subscribers nationwide.

Recent mergers by AT&T and Verizon have strengthened their competitive advantages by eliminating two leading competitors (MCI and legacy AT&T) in the

provision of in-region telecommunications services. The AT&T/BellSouth merger also consolidated control of Cingular (now AT&T Mobility, LLC), increasing AT&T's incentives to raise the costs of its wireless rivals through increased special access prices. The special access costs they had previously imposed on long distance companies and Cingular were suddenly converted into nothing more than entries on an accountant's worksheet – an internal intra-company transfer of dollars, thus further increasing their incentive to drive up special access costs.

The record in this proceeding overwhelmingly demonstrates that the combination of substantial barriers to entry, the general lack of special access competition, premature relaxation of regulation of interstate special access prices in many parts of the country where incumbents face little, if any, competition, and price cap mechanisms that do not match reality, have enabled the BOCs to maintain or increase supra-competitive prices that are constrained by neither competition nor government action. As Jim Cicconi, AT&T's Sr. Executive Vice President – External and Legislative Affairs, aptly recognized in 2003, it is only “[o]nce market forces are able to take root, and competition is able to emerge, [that] you can deregulate.” “But,” Mr. Cicconi continued “what happens when you deregulate incumbent monopolies? Do you magically get competition?”¹

The evidence provided to the Commission in this proceeding clearly demonstrates that neither magic nor reality has produced a competitive special access market. On the contrary, in those areas where regulation of the BOCs was relaxed prematurely, before competition was able to “take root,” special access rates have not fallen; in many cases

¹ “Beyond the Bubble,” THE ECONOMIST, Oct. 9, 2003, *available at*: <http://assets.wharton.upenn.edu/~faulhabe/732/Beyond%20the%20Bubble.html>.

they have increased. Moreover, the gap between the price-capped rates and the unconstrained BOC rates has typically increased over time, and the price-flexibility rates have remained substantially above the economic costs of at least one set of functionally identical offerings: high-capacity unbundled network element (“UNE”) loops and transport.

Like any company with market power, AT&T and Verizon use their market power because they can. They face little to no competition, and thus use their power to maximize their returns. Even in large urban areas, for example, Sprint Nextel remains dependent on BOC special access to meet its DS1 and DS3 needs. For example, in 2006, Sprint Nextel purchased 98% of its DS1 and DS3 circuits in Chicago from AT&T; 97% of its DS1 and DS3 circuits in Boston from Verizon; and 99% of its DS1 and DS3 circuits in San Francisco from AT&T.

Sprint Nextel constantly seeks alternatives to these two BOCs, but has had a striking lack of success in doing so. Responses to Sprint Nextel’s most recent alternative vendor questionnaire in January 2007, which was sent to 77 potential alternative vendors, show that only 16 such vendors had fiber facilities reaching only approximately 1% of over 52,000 Sprint Nextel cell sites nationwide covered by the questionnaire.

As a result of this lack of competition and the premature relaxation of regulation:

- The largest BOCs continue to reap *billions of dollars in excessive earnings* from special access, realizing *rates of return as high as one hundred percent*; and
- BOC special access prices remain at supra-competitive levels – in many instances *at least twice as high as the rates that one would expect to see in a competitive market.*²

² State Commissions, in contested proceedings, have determined the forward-looking costs for identical inputs that some carriers can purchase as UNEs. UNE loops

Excessive rates for special access services subsidize AT&T and Verizon at the expense of consumers, competition and the deployment of new and innovative services. As Verizon itself has recognized (in circumstances where it is a net buyer of access service), “subsidization harms consumers”³ and, moreover, services should be priced at “the cost of providing service, not serve as an uncapped, unending revenue source for certain carriers by requiring their competitors to subsidize them.”⁴ Even more troubling, these harms have long been a matter of public record, and the situation has deteriorated steadily since at least 2002, when pre-merger AT&T filed the Petition for Rulemaking that initiated this proceeding.

In light of the overwhelming evidence of the utter failure of the special access market and the lack of sufficient competition to drive prices down, attract new investment or ensure that buyers have alternatives, *it is critical that the Commission step in and act to constrain the excessive prices that have permeated the special access market for years.* Commission action to constrain AT&T and Verizon’s market power and to discipline prices for special access would go far in encouraging rapid deployment of broadband networks and promoting a competitive broadband market. As has been proven by the DSL-cable modem deployment wars, consumers can only benefit from the deployment of competitive broadband networks.

are equivalent to special access channel terminations and UNE transport is the equivalent of special access channel mileage. If competition existed, and the BOCs did not enjoy such dominant market power, special access prices would be steadily pushed closer to cost.

³ See Comments of Verizon Wireless, CC Docket No. 01-92, at 11 (Oct. 25, 2006) (“Verizon Wireless Oct. 25 Comments”); Comments of Verizon on the Missoula Plan, CC Docket No. 01-92, at 15-16 (Oct. 25, 2006) (“Verizon Oct. 25 Comments”).

⁴ Verizon Wireless Oct. 25 Comments at 11.

The Commission has an unambiguous statutory obligation to ensure that the rates that Sprint Nextel and other carriers and customers pay for special access are just and reasonable. Accordingly, *the Commission must promptly reinstate effective incentive regulation* to limit the exercise of market power by the BOCs, particularly AT&T and Verizon,⁵ in the provision of special access; and *replace its fundamentally flawed pricing flexibility rules* as quickly as possible. Specifically, the Commission should address the lack of competition in the special access market by immediately:

- *Reducing rates* for services the largest BOCs offer pursuant to Phase II pricing flexibility to rates no higher than their tariffed rates for such services in areas where they are subject to price caps;
- *Eliminating Phase II pricing flexibility* for the largest BOCs and placing all of their special access services under price caps, pending the adoption of new “triggers” for the grant of pricing flexibility;
- *Restating special access price cap indices* for the largest BOCs at levels that would have resulted if those BOCs had applied an X-Factor of 5.3% to those indices in July of 2004, 2005, 2006, and 2007; and
- *Applying an X-Factor of 5.3%* for special access services for the 2008 and subsequent annual access tariff filings by the largest BOCs, pending the Commission’s adoption of an updated adjustment factor.

In addition, for longer term relief, the FCC should *move the special access rates of the largest BOCs to reasonable levels* by requiring them no later than July 1, 2008 either to be based on forward-looking costs or to be targeted to earn a rate of return of no greater than 11.25%. Frankly, in light of the billions of dollars of excess revenues that these companies have generated over the past several years, a more fair and equitable result in

⁵ In addition to being the two largest price cap carriers, AT&T and Verizon are also the only two BOCs with significant shares of both the wireless and the enterprise business markets. Thus, they are the two carriers with the greatest incentives to use their dominant positions in the special access markets to harm competition in those downstream markets.

these circumstances would yield a refund of the excess charges. The Commission must address immediately AT&T's and Verizon's virtually unchecked power over special access.

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Attachment 1: Declaration of Gary B. Lindsey

Attachment 2: Declaration of Bridger M. Mitchell, CRA International

Exhibit 1: Comparison of Price Cap and Pricing Flexibility Rates

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Exhibit 3: Comparison of UNE vs. Special Access Rates

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COMMENTS OF SPRINT NEXTEL CORPORATION

Sprint Nextel Corporation (“Sprint Nextel”) submits these comments in response to the *Public Notice* issued by the Federal Communications Commission (“FCC” or “Commission”) on July 9, 2007 asking parties to refresh the record in the above-captioned proceedings regarding special access rates.¹

¹ Public Notice, “Parties Asked to Refresh Record in the *Special Access Notice of Proposed Rulemaking*,” WC Docket No. 05-25, FCC 07-123 (rel. July 9, 2007) (“*Public Notice*”).

I. INTRODUCTION

Special access² is the lifeblood of the telecommunications industry, touching a vast array of communications products. Every time consumers make wireless calls, access the Internet, send e-mails, swipe their credit cards at stores, or use an automated teller machine (“ATM”), they are using services that rely on special access. The record compiled in this proceeding to date demonstrates that interstate special access services, particularly DS1 and DS3 services, are priced at unreasonable levels and that the excessive rates harm both competition and consumers. Further, the record shows that to address this market failure the Commission must 1) promptly reinstate effective incentive regulation to limit the exercise of market power by the Bell Operating Companies (“BOCs”), particularly AT&T, Inc. (“AT&T”) and Verizon Communications, Inc. (“Verizon”),³ in the provision of special access; and 2) replace its fundamentally flawed pricing flexibility rule for special access as quickly as possible.⁴

² The Commission has defined special access as a dedicated transmission link between two locations. See *AT&T Inc. and BellSouth Corporation, Application for Transfer of Control*, Memorandum Opinion and Order, 22 FCC Rcd 5662, ¶ 27 n.88 (2007) (“*AT&T/BellSouth Merger Order*”), citing *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, ¶ 7 (2005) (“*2005 Special Access NPRM*”); see also *SBC Communications Inc. and AT&T Corp. Applications for Approval of Transfer of Control*, Memorandum Opinion & Order, 20 FCC Rcd 18290, ¶ 24 (2005) (“*SBC/AT&T Merger Order*”); *Verizon Communications Inc. and MCI, Inc. Applications for Approval of Transfer of Control*, Memorandum Opinion and Order, 20 FCC Rcd 18433, ¶ 24 (2005) (“*Verizon/MCI Merger Order*”). As this definition makes clear, “special access” includes any dedicated transmission link, regardless of the type of technology deployed over that link (including Ethernet and other packet-based services). See *AT&T/BellSouth Merger Order*, ¶ 27 n.88 (using the term “special access” to include *all* services that involve dedicated transmission links).

³ AT&T and Verizon are by far the largest providers of special access, accounting for 81% of incumbent local exchange carrier (“LEC”) special access service nationwide.

The comments and expert testimony filed in this proceeding to date provide clear evidence of a market failure for DS1 and DS3 special access services. Further, no changes have occurred since comments were filed in this proceeding in 2005 in response to the FCC's original Notice of Proposed Rulemaking ("NPRM")⁵ that would alter those

2006 FCC ARMIS Report 43-01, Table 1 – Cost and Revenue, Row 1090 (Total Operating Revenues), Column (s) (Special Access); they are also the largest providers of Commercial Mobile Radio Services ("CMRS"), together accounting for more than 51% of subscribers. See CTIA, "Wireless Quick Facts," available at: <http://www.ctia.org/media/industry_info/index.cfm/AID/10323> (233 million total wireless subscribers in the United States at the end of 2006); AT&T News Release, "AT&T Posts Strong Fourth-Quarter Earnings Growth, Reaffirms Outlook for Double-Digit Growth in Adjusted Earnings Per Share" (Jan. 25, 2007), available at: <<http://www.att.com/gen/press-room?pid=4800&cdvn=news&newsarticleid=23330>> (AT&T had 61 million wireless subscribers at the end of 2006); Verizon News Release, "Verizon's 4Q 2006 Results Cap Strong Year of Organic Growth in Wireless, Broadband and Business Markets" (Jan. 29, 2007), available at: <<http://investor.verizon.com/news/view.aspx?NewsID=813>> (Verizon Wireless had 59.1 million subscribers at the end of 2006). Consequently, independent wireless carriers, such as Sprint Nextel, often have no choice but to purchase special access, a critical input to CMRS and wireless broadband services, from their two biggest wireless competitors.

⁴ See, e.g., Comments of Nextel Communications, Inc., at 3-4, 26-27 ("2005 Nextel Comments"); Comments of the Ad Hoc Telecommunications Users Committee at 4, 37-43 ("2005 Ad Hoc Comments"); Comments of the American Petroleum Institute, at 10-12; Comments of AT&T Corp., at 2-6 ("2005 AT&T Comments"); Comments of ATX Communications Services, Inc., et al., at 2, 17-22 ("2005 ATX Comments"); Comments of PAETEC Communications, Inc., at 11-15; Comments of T-Mobile USA, Inc., at 20-21 ("2005 T-Mobile Comments"); Initial Comments of WilTel Communications, LLC, at 16-18 ("2005 WilTel Comments"); Comments of XO Communications, Inc., at 12 ("2005 XO Comments"). (Unless otherwise indicated, all comments cited herein were filed in WC Docket No. 05-25 on June 13, 2005.) Any relief granted in this proceeding should apply to all special access services, including those used to provide the packet-switched and Ethernet services that were the subject of Verizon's forbearance petition filed December 20, 2004, and amended in February 2006. See Petition of the Verizon Telephone Companies for Forbearance, WC Docket No. 04-440 (Dec. 20, 2004); Letter from Edward Shakin, Verizon, to Marlene Dortch, FCC Secretary, WC Docket No. 04-440 (Feb. 7, 2006); Letter from Susanne A. Guyer, Verizon, to Marlene Dortch, FCC Secretary, WC Docket No. 04-440 (Feb. 17, 2006).

⁵ 2005 Special Access NPRM, *supra* note 2.

conclusions. To the contrary, the situation has deteriorated steadily since 2002, when AT&T filed the Petition for Rulemaking that initiated this proceeding.⁶

As explained below:

- The largest BOCs continue to reap billions of dollars in excessive earnings from special access, *realizing rates of return as high as one hundred percent*;
- The pricing flexibility rules continue to be based on overly-broad geographic and product market definitions that allow the BOCs to gain *pricing flexibility before their special access offerings are subject to effective competition*;
- BOC special access prices, both those price capped and those subject to pricing flexibility, remain at *supra-competitive levels* – in many instances twice as high as the cost of the comparable unbundled network elements (“UNEs”); and
- Sprint Nextel, like other carriers, remains almost completely *dependent on its competitors*, the BOCs, for special access – particularly for DS1 and DS3 services for which there are virtually no viable alternatives in most areas.⁷

Moreover, the problem becomes increasingly more urgent every year, as special access continues to grow in importance. In 1990, when the FCC first adopted incentive regulation for incumbent local exchange carriers (“LECs”), special access only accounted

⁶ AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services, RM-10593 (Oct. 15, 2002).

⁷ Sprint Nextel actively seeks alternatives to BOC special access wherever possible. These efforts recently paid off as Sprint Nextel announced a backhaul agreement with FiberTower Corp. (“FiberTower”); *see* FiberTower News Release, “FiberTower Announces Backhaul Agreement with Sprint Nextel for WiMax Buildout” (Aug. 1, 2007), *available at*: <<http://www.firstavenet.com/corp/news-press-releases-080107.shtml>> (announcing agreement covering a portion of Sprint Nextel’s backhaul needs for 4G services in seven markets). Despite these extensive efforts, however, Sprint Nextel remains overwhelmingly dependent on the BOCs for its special access needs, even after the FiberTower deal. In fact, Sprint Nextel’s most significant alternative supplier of special access accounts for only 1% of Sprint Nextel’s total special access spending. *See* Declaration of Gary B. Lindsey, appended as Attachment 1, ¶ 11 (Aug. 8, 2007) (“Lindsey Decl.”).

for \$2.5 billion of the BOCs' revenues.⁸ Today, the BOCs are generating \$15.6 billion from special access, an amount representing over half their total revenues from interstate telecommunications services.⁹

Special access facilities are a significant input in the provision of both Commercial Mobile Radio Services ("CMRS") and wireless broadband services. Consequently, special access rates have a material effect on the prices that consumers pay for CMRS and wireless broadband services and on the availability and quality of those services. High special access costs harm consumers in several ways. Not only do these costs affect consumer pricing, but funds that companies like Sprint Nextel expend to pay their competitors, AT&T and Verizon, for over-priced special access services are not available for financing broadband deployment and network upgrades to enhance competitive carriers' ability to compete with the BOCs' wireless affiliates.¹⁰

Marketplace changes since 2005 have entrenched the dominant position of the BOCs in the provision of special access. In particular, recent mergers eliminated two leading competitors of the BOCs (MCI and legacy AT&T) in the provision of in-region telecommunications services. Those mergers also strengthened the competitive advantages of AT&T and Verizon in the provision of telecommunications services to

⁸ 1990 FCC ARMIS Report 43-01, Table 1 – Cost and Revenue, Row 1090, comparing special access revenue in Column (s) to interstate revenue in Column (h).

⁹ 2006 FCC ARMIS Report 43-01, Table 1 – Cost and Revenue, Row 1090, comparing special access revenue in Column (s) to interstate revenue in Column (h).

¹⁰ High special access rates also deter effective intermodal competition. As Verizon has recognized, "subsidization harms consumers" and "encourages overconsumption of the subsidized service . . . and underconsumption of other services." *See* Verizon Wireless Oct. 25 Comments at 11; Verizon Oct. 25 Comments at 15-16. In this case, excessive special access rates charged to wireless carriers not only allow AT&T and Verizon to subsidize their own wireless operations, they also raise wireless providers' costs, making it more difficult for independent wireless carriers to offer effective substitutes for landline residential service.

large and medium-sized business customers. Although SBC and Verizon agreed to temporary conditions in connection with their acquisitions of AT&T and MCI, respectively, those conditions provide only minimal short-term relief and do not diminish the continued dominance of the BOCs in the provision of special access service. Further, the short-term relief is limited to a temporary freeze of rates for certain special access services at the levels that existed at the time of the mergers.¹¹ The AT&T/BellSouth merger also consolidated control of Cingular (now AT&T Mobility, LLC (“AT&T Mobility”)), increasing AT&T’s incentives to raise the costs of its wireless rivals through increased special access prices.¹² After the mergers, the special access costs that they previously had imposed on AT&T, MCI and Cingular are now simply intra-company wealth transfers. Those excessive special access costs represent a very real – and very significant – cost to Sprint Nextel and other special access customers, however.

The Commission has an unambiguous statutory obligation to ensure that the rates that Sprint Nextel and other carriers and customers pay for special access are just and

¹¹ See *Verizon/MCI Merger Order*, Appendix G, Special Access Conditions 3 and 5; *SBC/AT&T Merger Order*, Appendix F, Special Access Conditions 3 and 5. As with the Verizon/MCI and SBC/AT&T merger conditions, the AT&T/BellSouth merger conditions do not adequately address excessive special access rates, even in the short-term. AT&T merely agreed to lower certain rates subject to pricing flexibility to the same levels as its tariffed rates for such services in areas where the BOC is subject to price caps, and to freeze those rates for 39 months. See *AT&T/BellSouth Merger Order*, Appendix F, Special Access Condition 6; *AT&T Inc. and BellSouth Corporation Application for Transfer of Control*, Order on Reconsideration, 22 FCC Rcd 6285, ¶ 5 (2007) (“*AT&T/BellSouth Merger Recon Order*”). This condition does not address the fact that even the rates subject to price caps are unreasonably high.

¹² By the time of the AT&T/BellSouth merger, Cingular had already grown considerably through its 2004 acquisition of AT&T Wireless, a large, independent wireless provider. See *Applications of AT&T Wireless Services, Inc. and Cingular Wireless Corporation for Consent to Transfer Control*, Memorandum Opinion and Order, 19 FCC Rcd 21522 (2004).

reasonable.¹³ Thus, the Commission must reduce special access rates and reinstate effective incentive regulation, unless and until the BOCs face effective competition in the provision of special access services. Specifically, the Commission should address the lack of competition in the special access market by immediately:

- *Reducing rates for services the largest BOCs¹⁴ offer pursuant to Phase II pricing flexibility to rates that are no higher than their tariffed rates for such services in areas where they are subject to price caps;*
- *Eliminating Phase II pricing flexibility for the largest BOCs and placing all of their special access services under price caps, pending the adoption of new “triggers” for the grant of pricing flexibility;*
- *Restating special access price cap indices for the largest BOCs at levels that would have resulted if those BOCs had applied an X-Factor of 5.3% to those indices in July of 2004, 2005, 2006, and 2007; and*
- *Applying an X-Factor of 5.3% for special access services for the 2008 and subsequent annual access tariff filings by the largest BOCs, pending the Commission’s adoption of an updated adjustment factor.*

In addition, for longer term relief, the FCC should move the special access rates of the largest BOCs to reasonable levels by requiring them, no later than July 1, 2008, either to be based on forward-looking costs¹⁵ or to be targeted to earn a rate of return of no greater than 11.25%.

¹³ 47 U.S.C. § 201(b).

¹⁴ Sprint Nextel’s comments – and proposed remedies – focus on AT&T and Verizon. In addition to being the two largest incumbent LECs, AT&T and Verizon are also the only two BOCs with significant shares of the wireless and enterprise business markets. Thus, they are the two carriers with the greatest incentives to use their dominant positions in the special access markets to harm competition in those downstream markets.

¹⁵ As Verizon Wireless has explained in a different proceeding concerning intercarrier compensation, the charges for telecommunications services should be based on “the cost of providing service, not serve as an uncapped, unending revenue source for certain carriers by requiring their competitors to subsidize them.” Verizon Wireless Oct. 25 Comments at 11. In this case, rates could be tied to costs by basing them on cost studies provided by the largest BOCs, or by using the cost-based rates established in state proceedings setting prices for comparable UNEs.

FCC action in this proceeding is critical to encouraging the rapid deployment of wireless broadband networks and promoting a competitive broadband market for consumers. There can be no doubt that the BOCs have long exercised – and continue to exercise – market power in the provision of the special access services that comprise a critical input to CMRS, wireless broadband and enterprise services. Thus, grant of the requested relief would produce significant, tangible benefits for consumers, including improved CMRS service quality and faster paced roll-out of broadband wireless.

II. THE BOCS CONTINUE TO REAP A WINDFALL FROM THE PROVISION OF SPECIAL ACCESS

Any claims that the special access market is effectively competitive are belied by the fact that the BOCs' special access earnings are exceedingly high, and continue to increase annually. For example, the rate of return for special access earned by SBC/AT&T has grown from 40% in 2000 to 100% in 2006.¹⁶ Verizon's rate of return for special access has more than tripled over the same time span, growing from 15% to 52%.¹⁷

In dollar terms, the magnitude of the over-earnings is astounding. In 2004, the difference between what the BOCs earned and what they would have earned at a healthy 11.25% rate of return¹⁸ amounted to more than \$6.3 billion. By 2006, that number had

¹⁶ FCC ARMIS Report 43-01, Table 1 – Cost and Revenue, Column (s) (Special Access), Row 1915 (Net Return) divided by Row 1910 (Average Net Investment).

¹⁷ FCC ARMIS Report 43-01, Table 1 – Cost and Revenue, Column (s) (Special Access), Row 1915 (Net Return) divided by Row 1910 (Average Net Investment).

¹⁸ 11.25% is the most recent rate of return that the Commission prescribed for cost-of-service incumbent local exchange carriers. *Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786, ¶ 7 (1990) (“*LEC Price Cap Order*”), *aff'd sub nom. Nat'l Rural Telecom Ass'n v. FCC*, 988 F.2d 174 (D.C. Cir. 1993); *Represcribing the Authorized Rate of Return for*

risen to \$7.4 billion, with Verizon and AT&T accounting for over \$6.3 billion of that total.¹⁹

The main factors contributing to these annual increases in special access over-earnings are (1) growing special access revenues that substantially exceed expense increases, and (2) declining net investment in special access. As Nextel noted in its 2005 comments, total BOC special access revenues increased by 45% between 2001 and 2004, while total operating expenses grew by only 21% and average net investment declined by 12% during that same period.²⁰

That trend has continued. For example, between 2000 and 2006, AT&T special access revenues increased by 53.1% while total operating expenses grew by only 19.5% and average net investment declined by 29.8%.²¹ Over this same time period, Verizon special access revenues increased 71.4% while total operating expense grew by only 28.3% and average net investment declined 23.0%.²² As a result, AT&T and Verizon combined have nearly tripled their total special access rate of return over this period, from 26.4% in 2000 to 72.1% in 2006. To the extent that AT&T and Verizon have been able to increase their revenues from special access by large amounts while their special

Interstate Services of Local Exchange Carriers, CC Docket No. 89-624, Order, 5 FCC Rcd 7507, ¶ 1 (1990).

¹⁹ Over-earnings were computed using Automated Reporting Management Information System (“ARMIS”) data ((Reported rate of return – 11.25)*ANI*Tax Factor).

²⁰ See 2005 Nextel Comments at 15.

²¹ FCC ARMIS Report 43-01, Table 1 – Cost and Revenue, AT&T, Inc., Rows 1090 (Total Operating Revenue), 1190 (Total Operating Expense), 1910 (Average Net Investment), Column (s) (Special Access).

²² FCC ARMIS Report 43-01, Table 1 – Cost and Revenue, Verizon Communications, Rows 1090 (Total Operating Revenue), 1190 (Total Operating Expense), 1910 (Average Net Investment), Column (s) (Special Access).

access expenses grew much more slowly and their net special access investment declined, it would appear that these companies have achieved significant productivity gains. Further, the market has not disciplined special access pricing by requiring AT&T and Verizon to share their productivity gains with their customers.²³

A. The BOCs are imposing special access rates that are not constrained by effective competition

Not surprisingly, the continuing increases in the BOCs' special access earnings have coincided with their gaining greater freedom in setting prices for special access services. According to the United States Government Accountability Office ("GAO"), by 2006, the BOCs had obtained Phase II flexibility for both channel terminations and channel mileage in 112 Metropolitan Statistical Areas ("MSAs") and had some form of pricing flexibility in 97 of the 100 largest MSAs.²⁴ As discussed below, the current pricing flexibility rules²⁵ are based on improper product and geographic market

²³ Significantly, unreasonably high special access charges has not attracted widespread entry by competing providers. See United States Government Accountability Office ("GAO"), Report to the Chairman, Committee on Government Reform, House of Representatives, *Telecommunications: FCC Needs to Improve its Ability to Monitor and Determine the Extent of Competition in Dedicated Access Services*, at 17 (Nov. 30, 2006), available at: <<http://www.gao.gov/new.items/d0780.pdf>> (noting that high special access rates would be expected to lead to increased competitive entry) ("GAO Report"). As explained below, this lack of competition is due to a number of factors, including the barriers to entry faced by potential competitors, as well as BOC practices that are designed to deter competitive entry. See Section III.B., *infra*; see also GAO Report at 13, 18.

²⁴ GAO Report at 6.

²⁵ The current triggers allow price cap LECs to be granted pricing flexibility in any MSA in which a competitor has collocated equipment in a certain percentage of wire centers. The triggers vary for Phase I and Phase II pricing flexibility and the thresholds are different for channel terminations and for channel mileage (dedicated transport). See *Access Charge Reform*, Fifth Report and Order and Further Notice of Proposed Rulemaking, 14 FCC Rcd 14221 (1999) ("*Pricing Flexibility Order*").

definitions and, consequently, have allowed the BOCs to obtain relief for products and in areas where their prices are not constrained by effective competition.²⁶

1. Product Market

The relevant product markets for special access services must be defined in relation to both the function and the transmission capacity of the relevant circuits.²⁷ The relevant product markets for special access include: a) channel terminations between a BOC's end office and a customer's location (including, in Sprint Nextel's case, cell sites); b) channel mileage between two BOC offices; and c) entrance facilities between a BOC's wire center and a competitive carrier's point of presence or mobile switching center. Each of these services performs separate functions within the network and none of these services is fungible with any other of these services.²⁸

For instance, channel termination circuits are not substitutes for channel mileage circuits because each connects different points in the network. In Sprint Nextel's case, channel terminations connect cell site locations with BOC central offices, whereas

²⁶ The current pricing flexibility rules are based on the premise that competition will constrain the BOCs' prices in areas where they have been granted pricing flexibility. *Pricing Flexibility Order* ¶ 144 (“[i]f an incumbent LEC charges an unreasonably high rate for access to an area that lacks a competitive alternative, that rate will induce competitive entry, and that entry will in turn drive rates down”); *see also* GAO Report at 6 (“[t]he basic economic theory underlying FCC's regulatory approach postulates that greater competition should constrain incumbent pricing power and drive prices toward the marginal cost of providing” special access services). As the record has shown, however, that necessary competition failed to develop, leaving prices far above economically efficient levels.

²⁷ *See* 2005 Nextel Comments at 4, 8-9; 2005 Ad Hoc Comments at 50; 2005 T-Mobile Comments at 16; Comments of Time Warner Telecom at 6 (“2005 Time Warner Telecom Comments”); Comments of CompTel/ALTS, *et al.*, at 3 (“2005 CompTel/ALTS Comments”).

²⁸ *See* Declaration of Bridger M. Mitchell, appended as Attachment 2, ¶ 14 (Aug. 8, 2007) (“Mitchell Decl.”).

channel mileage circuits connect two central offices or a central office and a tandem office. Moreover, the Commission has previously recognized that the economics of deploying each type of facility, and therefore the prospects for competitive entry, vary significantly. Thus, the fact that a firm has deployed an alternative facility between two BOC offices says virtually nothing about the prospects for the construction of a competitive channel termination between a specific cell site and a specific central office.²⁹

The product market, however, cannot be defined solely on the basis of the discrete functions of each type of circuit; it must also reflect the capacity differences between special access circuits.³⁰ Sprint Nextel, for example, relies almost exclusively on DS1 channel terminations to serve its tens of thousands of cell sites. A DS3 circuit has 28 times the capacity of a DS1 circuit and, consequently, is not a realistic alternative for low volume, cell-site-to-central-office routes.³¹ Similarly, a DS1 circuit cannot be a substitute for a DS3 circuit on routes that require DS3 capacity. Further, as the Commission has

²⁹ For example, the Commission has concluded that the economics of constructing last-mile facilities to a customer location create “substantial” barriers to entry. *Unbundled Access to Network Elements*, Order on Remand, 20 FCC Rcd 2533, ¶ 153 (2005) (“*UNE TRRO*”) (discussing loops). The discussion of loops in the *UNE TRRO* is equally applicable to special access channel terminations, since loops and channel terminations serve identical purposes in a network. *See, e.g., Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, 18 FCC Rcd 16978, ¶ 593 & n.1825, corrected by Errata, 18 FCC Rcd 19020 (2003) (“*UNE TRO*”) (drawing an analogy between a special access channel termination and a UNE loop); GAO Report at 4 (noting that a channel termination is sometimes referred to as a “local loop”).

³⁰ *See Mitchell Decl.* ¶ 15.

³¹ As Dr. Mitchell points out, however, a DS3 circuit may be an effective substitute for locations with multiple DS1s worth of demand. *See Mitchell Decl.* ¶ 16.

recognized, the capacity required to serve a particular route has a material effect on the economics of deploying competitive facilities.³²

Thus, it is clear that DS1 channel terminations, DS3 channel terminations, DS1 channel mileage, DS3 channel mileage, and entrance facilities are each different services that meet different needs, and are not substitutes for one another from the perspective of customers or would-be competitive entrants.³³ The Commission must revise its special access pricing flexibility rules to reflect these proper product market definitions.

2. Geographic Market

The relevant geographic market for purposes of conducting a competitive analysis is an “area in which all customers in that area will likely face the same competitive alternatives for a product.”³⁴ The FCC used the MSA as the relevant geographic market for purposes of granting pricing flexibility.³⁵ An MSA, however, is much too large an

³² See, e.g., *TRRO* ¶ 72. For example, a competitive provider may be able to create a successful business case for serving a particular route or site with DS3 or OCn level services, but may not be able to generate a sufficient return on routes or to sites with only DS1 levels of demand. See GAO Report at 13 (noting that it is unlikely to be economically viable for competitors to extend their networks to locations with less than 3 or 4 DS1s worth of demand).

³³ See, e.g., 2005 Time Warner Telecom Comments at 6; 2005 T-Mobile Comments at 16; 2005 ATX Comments at 30; 2005 CompTel/ALTS Comments at 3.

³⁴ *Applications of Ameritech Corp. and SBC Communications Inc. for Consent to Transfer Control*, Memorandum Opinion and Order, 14 FCC Rcd 14712, ¶ 69 n.147 (1999); see also *Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area and Policy and Rules Concerning the Interstate, Interexchange Marketplace*, 12 FCC Rcd 15756, ¶ 28 (1997) (“*LEC Classification Order*”) (explaining that the FCC determines the relevant geographic market by considering whether, if all carriers raised their prices in a specific area, a customer would be unable to find the same service in another area at a lower price).

³⁵ *Pricing Flexibility Order* ¶¶ 72-74. The FCC relies on the Office of Management and Budget’s (“OMB’s”) definition of MSAs. As defined by OMB, MSAs consist of one or more counties and can encompass multiple urban areas (e.g., the Miami-Fort Lauderdale-Pompano Beach, FL MSA includes the following principal cities: Miami,

area for purposes of determining whether special access services are subject to effective competition,³⁶ because competitive conditions vary widely within a single MSA.³⁷ Thus, for example, competition in one part of an MSA is unlikely to constrain BOC special access pricing in another geographic area within the same MSA.³⁸ The fact that there may be competing providers offering dedicated circuits between customer premises and BOC central offices in some parts of an MSA is of no help whatsoever in addressing Sprint Nextel's need for a circuit to connect a particular cell site in another part of the same MSA with the central office serving that cell site.³⁹

An MSA-wide market definition is also inconsistent with the economics of providing special access services. For example, providing special access service to an entire MSA would require an entrant to make a substantial up-front investment essentially to duplicate the BOCs' existing network. That approach, however, would make no sense as a matter of economics, because it would require an up-front investment in facilities along low-volume routes where there is a substantial risk that the entrant

Fort Lauderdale, Pompano Beach, West Palm Beach, Miami Beach, Kendall, Boca Raton, Deerfield Beach, Boynton Beach, and Delray Beach). *See* "Metropolitan and Micropolitan Statistical Area Definitions," U.S. Census Bureau, *available at*: <<http://www.census.gov/population/www/estimates/metrodef.html>>.

³⁶ *See* 2005 Nextel Comments at 8; 2005 Comments of Sprint Corporation at 9; 2005 T-Mobile Comments at 5, 15; 2005 XO Comments at 9, 11; *see also* 2005 Time Warner Telecom Comments at 7, 25; 2005 WilTel Comments at 22.

³⁷ *See, e.g., TRRO* ¶ 155; *see also* Reply Comments of WorldCom, Inc., RM-10593, at 9-10 (Jan. 23, 2003) ("2003 WorldCom Reply"); Reply Declaration of Dr. Lee Selwyn, ¶ 20, attached as Exhibit 3 to Reply Comments of AT&T Corp., RM-10593 (Jan. 23, 2003) ("2003 AT&T Reply").

³⁸ *See* Mitchell Decl. ¶¶ 27-28

³⁹ *See* Declaration of Bridger M. Mitchell and John R. Woodbury, filed as Attachment 1 to Reply Comments of Nextel Communications, Inc., WC Docket No. 05-25, ¶¶ 36, 39 (July 29, 2005) ("2005 Mitchell-Woodbury Decl." and "2005 Nextel Reply"); *see also* Mitchell Decl. ¶¶ 26-29

would not be able to attract sufficient demand to recoup its investment.⁴⁰ Experience has shown that new entrants logically target their entry to specific routes with high demand where they have the most favorable prospects for attracting adequate demand to recover their sunk investment.⁴¹

Moreover, the FCC properly rejected the use of MSAs as the relevant geographic market for both dedicated transport as well as high capacity loops in the *UNE TRRO*.⁴² The Commission noted that an MSA approach “would require an inappropriate level of abstraction, lumping together areas in which the prospects for competitive entry are widely disparate.”⁴³ The Commission, instead, adopted a narrower market definition, based on wire centers, that takes into account routing, line density and the number of fiber-based collocators in each wire center.⁴⁴

The relevant geographic market for special access, therefore, is the geographic area served by a route connecting the two points that a purchaser seeks to link with the dedicated facility (*e.g.*, cell site and central office, or central office and access tandem).⁴⁵ At a maximum, the relevant geographic market for loops/channel terminations is the wire

⁴⁰ See, *e.g.*, GAO Report at 13, 26.

⁴¹ See Mitchell Decl. ¶¶ 30-32.

⁴² *UNE TRRO* ¶¶ 82, 155, 164. UNE loops are equivalent to special access channel terminations and UNE transport is the equivalent of special access channel mileage. See, *e.g.*, *UNE TRO* ¶ 593 & n.1825 (drawing an analogy between a special access channel termination and a UNE loop).

⁴³ *UNE TRRO* at ¶ 155.

⁴⁴ *Id.* ¶¶ 66, 168.

⁴⁵ See, *e.g.*, *LEC Classification Order* ¶ 65 n.176. The Commission has concluded repeatedly that markets for exchange access services like special access are “point-to-point” markets or markets of “discrete local areas.” *Application of WorldCom, Inc. and MCI Communications Corporation for Transfer of Control*, Memorandum Opinion and Order, 13 FCC Rcd 18025, ¶ 166 (1998); *LEC Classification Order* ¶ 67.

center serving a specific customer location,⁴⁶ because channel terminations provided in an area served by one serving wire center cannot substitute for channel terminations provided out of another serving wire center. Similarly, the relevant geographic market for interoffice transport/channel mileage is the route between the two central offices being connected,⁴⁷ because the availability of dedicated connections between one pair of BOC central offices cannot substitute for a circuit connecting another pair of central offices.

In sum, the Commission's pricing flexibility triggers are based on improper market definitions. Both the product and geographic markets are defined too broadly and, consequently, reflect a distorted view of the special access marketplace. Moreover, the FCC based its triggers on the presence of collocation in a certain percentage of wire centers in an MSA, ignoring whether competitive facilities actually have been deployed to any particular location or any particular route and ignoring the differences between DS1 and DS3 capacity circuits.⁴⁸ As explained below, this deregulation of special access services has had a significant impact in the marketplace, harming both competitive carriers and consumers of wireless and other services that depend on special access as a critical input.

If the FCC's triggers were reliable indicators of the presence of alternative providers of special access, one would reasonably expect that special access rates in those

⁴⁶ See *TRRO* ¶ 155.

⁴⁷ See *TRRO* ¶¶ 78-79.

⁴⁸ In Sprint Nextel's experience, virtually no competitive providers collocate for purposes of providing channel terminations to serve cell sites. Thus, although competitive collocation may arguably be a useful measure for assessing the availability of competitive interoffice transport, it has almost no bearing on the availability of competitive channel terminations at any particular customer location.

areas would be lower than the rates charged in areas that did not satisfy the triggers.⁴⁹ In reality, however, the BOCs' prices in areas where they have been granted Phase II pricing flexibility generally remain as high, and in most cases higher, than their rates in areas where they are still subject to price caps.⁵⁰ Moreover, as explained in Section III below, special access rates are far above economically efficient levels.⁵¹

The failure to apply a proper geographic market definition has enabled the BOCs to obtain pricing flexibility prematurely in areas where they face little or no competition.⁵² This has had several adverse consequences. The most obvious impact is the harm imposed on consumers of services such as CMRS and wireless broadband that depend on special access as an input. These consumers pay the cost of inflated special

⁴⁹ In a competitive market, rates should be driven towards marginal costs (*i.e.*, the long-run incremental costs of the service, including recovery of fixed costs specific to the service). *See, e.g.*, GAO Report at 6; *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, 11 FCC Rcd 15499, ¶¶ 672, 679 (1996) (“*Local Competition Order*”) (adopting TELRIC); *aff’d sub nom. Verizon v. FCC*, 535 U.S. 467 (2002) (upholding TELRIC pricing).

⁵⁰ *See, e.g.*, GAO report at 13, 27-28; *see also* Comparison of Price Cap and Pricing Flexibility Rates, attached as Exhibit 1. There are a few exceptions, which may indicate pockets of the country where competition is imposing some constraint on BOC pricing. For example, in AT&T’s Pacific Bell Region some services subject to pricing flexibility are priced lower than comparable services subject to price caps. In addition, some month-to-month rates in AT&T’s Ameritech region are higher in areas subject to price caps than they are in areas subject to pricing flexibility.

⁵¹ *See* section III, *infra*. Sprint Nextel’s experiences reinforce the conclusion that the existing pricing flexibility triggers are unreliable indicators of the presence of alternative providers. Sprint Nextel has found virtually no difference in its ability to use competitive alternatives in markets subject to price caps compared to markets where the BOCs have full pricing flexibility. *See, e.g.*, section IV, *infra*.

⁵² Tellingly, the GAO’s analysis revealed that the “theoretically more competitive phase II areas generally have a lower percentage of [competitively] lit buildings than phase I areas.” GAO Report at 12.

access rates in the form of both higher retail rates for downstream services,⁵³ as well as reduced deployment of cell sites and other infrastructure.

Another, less obvious, consequence of the current pricing flexibility rules is that they permit the BOCs to use their pricing flexibility for certain special access services to increase the prices for those services to levels that effectively allow them to capture monopoly rents for services that remain subject to price caps. Assume, for example, that a BOC has been granted pricing flexibility for channel mileage services in an MSA, but its channel termination services in that MSA remain subject to price caps. The pricing flexibility rules permit the BOC to set the price for channel mileage on routes where it faces no competitive constraint at a level that captures the total monopoly price for both channel mileage and channel termination services, despite the fact that the latter remain subject to price regulation.⁵⁴

B. Special access price indices have not been reduced for the past several years to account for the BOCs' productivity gains

The rates for BOC special access services that remain under price caps are also substantially above reasonable levels, because the current rules do not require the BOCs to lower their price cap indices each year to reflect increases in productivity via the

⁵³ Because lower special access prices would put downward pressure on the retail prices of all CMRS providers, the customers of the AT&T and Verizon wireless affiliates also would benefit.

⁵⁴ See Mitchell Decl. ¶¶ 41-42. This strategy is particularly effective for customers that prefer to obtain both channel mileage and channel termination from a single vendor. See, e.g., Declaration of Steven Sachs, filed as Attachment 2 to 2005 Nextel Reply, ¶ 7 (July 29, 2005) (explaining that purchasing channel mileage and channel terminations from separate vendors makes it more difficult to resolve outages).

application of an X-Factor, net of inflation.⁵⁵ Instead, under the Coalition for Affordable Local and Long Distance Services (“CALLS”) Plan, the X-factor for price capped services has been set equal to inflation since July 2004.⁵⁶ Consequently, the BOCs have been permitted to retain all of the productivity gains that they have realized in the provision of special access for the past three years.⁵⁷

Moreover, there is credible evidence that those productivity gains have been substantial. Economics and Technology, Inc.'s (“ETI’s”) special access-specific study, submitted previously in this docket, found a productivity factor of 11.01%.⁵⁸ Sprint Nextel has updated that study to include data from 2005 and 2006, the results of which are included as Exhibit 2 to these comments.⁵⁹ Inclusion of those data indicate that the

⁵⁵ The X-factor is a mechanism “aimed at capturing a portion of expected increases in carrier productivity, so that these improvements, as under competition, will result in lower prices for consumers.” *United States Tel. Ass’n v. FCC*, 188 F.3d 521, 524 (D.C. Cir. 1999).

⁵⁶ See *Access Charge Reform*, 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 Order*”); see also GAO Report at 6. The CALLS Plan was a joint proposal by several large carriers that was intended to address issues related to universal service, switched access charges, and charges for price-cap dedicated access services. The CALLS coalition included legacy AT&T, Bell Atlantic Telephone Companies, BellSouth Corporation, GTE Service Corporation, SBC Communications Inc. and Sprint Corporation. The CALLS Plan was intended to expire in June 2005, but the rules adopted by the FCC’s 2000 order remain in effect until the FCC takes further action. See *CALLS Order*; GAO Report at 5-6.

⁵⁷ The only changes in price cap indices since July 2004 have been very small exogenous cost adjustments. Almost all of these exogenous cost changes have been directed to the Common Line basket, except for a small proportion directed to the percentage of the special access basket services that are sold to end users.

⁵⁸ See 2005 Ad Hoc Comments.

⁵⁹ See Exhibit 2.

BOCs' special access productivity has remained strong, suggesting an achieved annual productivity gain of nearly 17%.⁶⁰

The BOCs have taken full advantage of the current regime by maintaining their actual price indices ("APIs") for special access at or near their price cap indices ("PCIs"). For example, Verizon's special access API for the 2007-08 tariff year is equal to its special access PCI.⁶¹ In other words, Verizon's prices are set at the maximum permissible levels. AT&T's special access API for the current tariff year similarly is just slightly below its special access PCI.⁶²

Since the special access services that remain under price caps are offered in areas where the BOCs cannot satisfy even the existing triggers for Phase II pricing flexibility, competition plainly will not put downward pressure on those charges. Only the re-introduction of an effective incentive regime – one that takes into account increases in productivity – will provide meaningful relief from substantial overcharges. Otherwise,

⁶⁰ See *id.*

⁶¹ See Verizon Tariffs FCC Nos. 1, 11, 14, 16, and 20, Transmittal No. 821, Form IND-1, line 899 (June 15, 2007), *available at*: <http://svartifoss2.fcc.gov/cgi-bin/ws.exe/prod/ccb/etfs/bin/binary_out.pl?96969>.

⁶² See Ameritech Tariff FCC No. 2, Transmittal No. 1629, Form IND-1, line 899 (June 15, 2007), *available at*: <http://svartifoss2.fcc.gov/cgi-bin/ws.exe/prod/ccb/etfs/bin/binary_out.pl?97077>; BellSouth Tariff FCC No. 1, Transmittal No. 1080, Form IND-1, line 899 (June 15, 2007), *available at*: <http://fjallfoss.fcc.gov/cgi-bin/ws.exe/prod/ccb/etfs/bin/binary_out.pl?95972>; Nevada Bell Tariff FCC No. 1, Transmittal No. 159, Form IND-1, line 899 (June 15, 2007), *available at*: <http://svartifoss2.fcc.gov/cgi-bin/ws.exe/prod/ccb/etfs/bin/binary_out.pl?97092>; Pacific Bell Tariff FCC No. 1, Transmittal No. 355, Form IND-1, line 899 (June 15, 2007), *available at*: <http://svartifoss2.fcc.gov/cgi-bin/ws.exe/prod/ccb/etfs/bin/binary_out.pl?97085>; SNET Tariff FCC No. 39, Transmittal No. 947, Form IND-1, line 899 (June 15, 2007), *available at*: <http://svartifoss2.fcc.gov/cgi-bin/ws.exe/prod/ccb/etfs/bin/binary_out.pl?97099>; SWBT Tariff FCC No. 73, Transmittal No. 3212, Form IND-1, line 899 (June 15, 2007), *available at*: <http://svartifoss2.fcc.gov/cgi-bin/ws.exe/prod/ccb/etfs/bin/binary_out.pl?97070>.

without competitive pressure to reduce prices, the BOCs will naturally have an incentive to charge the maximum permissible rate.

The Commission, in the *2005 NPRM*, recognized that the BOCs have earned special access rates of return substantially in excess of the prescribed 11.25% rate of return. Acknowledging that the CALLS plan would expire by July 2005, the Commission therefore anticipated adopting an order prior to July 1, 2005 that provided an interim plan to ensure charges were just and reasonable.⁶³ Two years later, these prices remain inflated and unchecked by either competition or appropriate Commission restraints.

III. BOC SPECIAL ACCESS PRICES SUBSTANTIALLY EXCEED ECONOMICALLY EFFICIENT LEVELS

The record from 2005 contained substantial evidence that special access rates were unreasonably high. More recent analyses show that the situation has not improved over the last two years. Further, the BOCs' special access offerings contain provisions designed to take advantage of the BOCs' market power in the provision of special access services to ensure that customers continue to pay inflated rates.

A. Special access prices are set well above economically efficient levels

There can be little dispute that prices should be based on the costs of providing service.⁶⁴ Yet, there is compelling evidence that special access rates significantly exceed the economic costs of providing special access service. Sprint Nextel recently compared special access rates in a sample of AT&T and Verizon states with the charges for comparable UNEs. The latter are prices for DS1s and DS3s that are established pursuant

⁶³ *2005 Special Access NPRM* ¶ 131.

⁶⁴ *See, e.g.*, Verizon Wireless Oct. 25 Comments at 11 (“[c]ompensation should be provided with reference to the cost of providing service.”)

to Commission pricing rules that are based on forward-looking costs and designed to produce rates that approximate those that a competitive market would produce.⁶⁵ As discussed below, the Sprint Nextel analysis shows that special access prices far exceed the prices for comparable UNEs.⁶⁶ It bears emphasis that the special access rates examined by Sprint Nextel were those offered by the BOCs in exchange for a five-year term commitment, which generally reflect the most generous discounts. Moreover, as noted above, the prices for special access services that remain under price caps generally are no higher than, and often are lower than, the prices for comparable services for which the BOCs have obtained Phase II flexibility.

Sprint Nextel examined special access and UNE rates in five states in AT&T's region: California, Michigan, Ohio, Texas and Wisconsin. This analysis revealed that prices for ten-mile DS1 special access circuits – consisting of two channel terminations and one ten-mile channel mileage circuit – are, on average, 150% higher than the prices

⁶⁵ See *Local Competition Order* ¶ 679; *aff'd sub nom. Verizon v. FCC*, 535 U.S. 467 (2002). These UNE rates were set in contested proceedings – involving full discovery and cross examinations – in which the BOCs were active participants.

⁶⁶ See T-Mobile Comments, WC Docket No. 04-313, at 21-22 and attached Declaration of Michael A. Williams at Appendix B (Oct. 4, 2004) (“Williams Decl.”) (showing that the prices incumbent LECs charged for special access DS1 channel termination services were approximately twice the prices, on average, for comparable UNE loops); Declaration of M. Joseph Stith, ¶ 2, attached to 2005 Ad Hoc Comments (showing that the BOCs’ tariffed rates for a typical 10-mile special access circuit – including two channel terminations, a fixed mileage transport charge and a ten-mile channel mileage circuit – were, on average “significantly above their rates for equivalent UNEs,” in many cases “by well over 100%.”) T-Mobile’s analysis also showed that even UNE prices, though closer to competitive rates than the special access prices, were still substantially higher than the prices that would prevail in a competitive market. Williams Decl. ¶ 33.

for comparable UNE circuits.⁶⁷ In the same five states, special access prices for ten-mile DS3 circuits are, on average, 49% higher than the rates for comparable UNE circuits.⁶⁸

Sprint Nextel conducted a similar analysis of four states in Verizon's region: Maryland, Massachusetts, New York and Pennsylvania. This analysis showed that prices for ten-mile DS1 special access circuits are, on average, 58% higher than the prices for comparable UNE circuits.⁶⁹ In the same four states, prices for ten-mile DS3 special access circuits are, on average, 36% higher than the rates for comparable UNE circuits.⁷⁰

Other market-based evidence buttresses the conclusion that the BOCs' special access prices are set well above economically efficient levels. For example, DSL service provides speeds comparable to a DS1. AT&T and Verizon face direct competition from cable companies in the provision of high-speed internet access to residential consumers. In the face of that competition, the BOCs price their retail DSL service – which recovers the cost of the loop, transport and information services – at \$20-30 per month,⁷¹ whereas the typical price for a comparable DS1 channel termination – which covers the cost of the loop alone – exceeds \$100.⁷² Even more striking is the fact that Verizon charges only \$39.99 a month for its

⁶⁷ See Comparison of AT&T and Verizon Special Access Rates and Unbundled Network Element Rates, attached as Exhibit 3.

⁶⁸ See *id.*

⁶⁹ See *id.*

⁷⁰ See *id.*

⁷¹ See AT&T Featured Services, available at: <<http://www.att.com/gen/general?pid=6431>> (offering Pro DSL – 50x dial-up – for \$24.99 per month; Verizon High Speed Internet, available at: <<http://www22.verizon.com/content/consumerdsl/plans/all+plans>> (offering Power Plan DSL – 53x faster than dial-up – for \$19.99 per month for the first 6 months and \$29.99 thereafter).

⁷² See Exhibit 3 at 2 (showing the simple average access DS1 CT is \$124.92).

slowest speed FiOS offering (5 Mbps download/2 Mbps upload);⁷³ a DS1 special access circuit provides only 1.544 Mbps in both directions.

B. The BOCs engage in practices designed to maintain special access rates at unreasonable levels

As shown above, market forces have not put downward pressure on the BOCs' special access prices despite ample evidence that costs have been declining steadily. Such supra-competitive prices would be expected to attract entry by efficient competitors.⁷⁴ As noted above, however, the economic barriers confronting potential providers of competing special access services are substantial.⁷⁵ Moreover, the BOCs – particularly AT&T and Verizon – have engaged in various practices that thwart competition and maintain their dominance over special access.⁷⁶ One of these strategies is the use of exclusionary pricing practices intended to induce customers to enter into service arrangements that effectively prevent them from migrating traffic from BOC special access services to their own facilities or those provided by competing suppliers.⁷⁷

⁷³ See Verizon FiOS Internet, available at: <<http://www22.verizon.com/content/ConsumerFios/>>.

⁷⁴ See, e.g., *Pricing Flexibility Order* ¶ 144 (predicting that if an incumbent LEC charged unreasonably high rates for access services it would attract competitive entry); GAO Report at 17.

⁷⁵ Barriers to entry include, but are not limited to, the costs of the fiber and electronics, the need to secure rights-of-ways in order to dig up streets before laying fiber, and the need to obtain access to buildings. See, e.g., GAO report at 13; *TRRO* ¶¶ 150-153.

⁷⁶ See GAO Report at 18.

⁷⁷ See, e.g., GAO Report at 30-31. Other strategies involve poor performance in the ordering, provisioning, maintenance and repair of special access services (see *Performance Measurements and Standards for Interstate Special Access Services*, Notice of Proposed Rulemaking, 16 FCC Rcd 20896 (2001)), and practices designed to discourage customers from migrating or “grooming” circuits off of the BOCs’ networks. See, e.g., Letter from Henry G. Hultquist, WorldCom, to Marlene Dortch, FCC Secretary, and attached presentation, CC Docket No. 01-338 (Oct. 4, 2002) (describing

Companies in various industries often provide services to customers under exclusive arrangements that “lock up” the demand of the purchaser for the supplier’s services and prohibit the customer from looking elsewhere for those services. In competitive markets with multiple suppliers, such exclusive arrangements generally do not result in competitive harm.⁷⁸ In markets dominated by a single supplier, however, exclusive arrangements raise the cost of the supplier’s rivals to provide competitive services and increase the dominant supplier’s power over the price of those services.⁷⁹

In a market where a competitor must obtain a substantial share of the existing market to achieve economies of scale, a company with market power need deter only a small fraction of its customers from switching providers to convince a potential rival not to enter the market.⁸⁰ The key to successful exclusionary pricing is to condition more attractive pricing for the non-competitive portion of the customer’s needs on the selection of the dominant firm for the competitively sensitive portion of the customer’s

unreasonable grooming practices by the BOCs). These strategies are made more effective by the high sunk costs that deter competitive entry into the special access business.

⁷⁸ In competitive markets, customers can choose between different suppliers to satisfy their demand. Exclusionary or anti-competitive possibilities arise when there is only one firm capable of meeting each customer’s entire demand. In that situation, the dominant company can use exclusive arrangements to preclude incremental competitive entry. See *Anticompetitive Exclusion: Raising Rivals’ Costs to Achieve Power over Price*, T. Krattenmaker & S. Salop, 96 Yale L.J. 209; *LePage’s Inc. v. 3M*, 324 F.3d 141, 158 (2003) (citations omitted) (“[d]iscounts conditioned on exclusivity are ‘problematic’ ‘when the [supplier] is a dominant firm in a position to force manufacturers to make an all-or-nothing choice.’”).

⁷⁹ Exclusionary pricing schemes are particularly attractive to dominant firms, such as the BOCs, because exclusionary pricing – unlike predatory pricing, for example – does not require the company with market power to set prices below its own costs. Exclusionary pricing therefore can be virtually costless to the dominant company.

⁸⁰ Less than full requirements contracts can be exclusionary if they tie up sufficient volume to prevent smaller competitors from achieving minimum viable scale.

requirements. In other words, a customer pays a higher price for the non-competitive services if it purchases the competitively sensitive services from another provider.

AT&T and Verizon have adopted such exclusionary pricing strategies in their provision of special access. AT&T and Verizon dominate the provision of both channel terminations and channel mileage. *No other supplier can satisfy the entire demand for those services in the AT&T and Verizon regions.* AT&T and Verizon have used these advantages to forestall competition.

For example, to discourage a customer from purchasing special access service from alternative providers, AT&T and Verizon condition special access discounts on a customer's commitment to obtain virtually all of its access needs from the incumbent. The exclusivity of the arrangement is reinforced further by the use of discounts that escalate over time and the imposition of significant early termination penalties. The net effect is that AT&T's and Verizon's special access customers are deterred from seeking alternative suppliers even in those markets where competing services are available. The result is to deter competitive entry by limiting demand for competitive access services.

AT&T and Verizon also have long used discount plans that discourage the use of alternative suppliers by requiring carrier customers to commit to continue purchasing services worth 90% or more of current spending levels from the BOCs, for the term of the contract. Although described as discounts by AT&T and Verizon, some of these pricing practices are more accurately described as penalties that punish customers that do not buy the vast majority of their services from the BOC. Because AT&T's and Verizon's baseline rates are well above competitive levels, the discounts they offer to customers do not generate genuine "savings" compared to the rates that would be

available to customers in a competitive market. Many of AT&T's and Verizon's "discount" provisions also impose penalty payments if the customer fails to meet the required volume commitments.⁸¹ The magnitude of the penalties discourages competitive entry by making it uneconomic for a customer to self-provision or to subscribe to a competitive provider.

AT&T and Verizon also restrain competition by linking the discounts to historical demand levels of their purchasers. In markets where the purchaser's level of output is decreasing, these limits can further restrain a purchaser's ability to seek competitive sources of access services. For example, assume that Purchaser X's discount for special access services was based on an historical annualized amount of \$100 million. Further assume that Purchaser X was eligible for the discount only if 90% or more of its special access needs were purchased from the incumbent. If X's sales decreased and X only purchased \$90 million from the incumbent, X could not purchase any access services from the incumbent's competitors without losing the discount and becoming liable for contractual penalties.

A review of AT&T's special access tariff helps demonstrate the manner in which it uses exclusionary pricing schemes to discourage competitive entry. AT&T has tariffed a high-capacity service discount plan under its pricing flexibility contract offerings, referred to as the "MVP Plan."⁸² Under the MVP plan, a carrier customer that meets certain criteria is eligible to receive a 50% discount off AT&T's recurring tariff rates for

⁸¹ Reply Declaration of Joseph Farrell, attached to Reply Comments of CompTel, *et al.*, WC Docket No. 05-25 (July 29, 2005); GAO Report at 30.

⁸² Ameritech Operating Companies, Tariff FCC No. 2, § 22.20, p. 22-122 (filed Nov. 17, 2003 under Transmittal No. 1369; effective Nov. 18, 2003) ("Ameritech Tariff Transmittal 1369").

DS1, DS3, and OCn services.⁸³ To obtain the MVP discount, the customer must not only purchase a minimum of 95% of its special access services at the tariffed rates,⁸⁴ it must also demonstrate to AT&T that four percent of all services purchased under the plan were previously provided by a carrier other than AT&T or its affiliates.⁸⁵ Failure to meet these requirements triggers a termination liability obligation equal to 100% of all discounts received during the previous six months.⁸⁶

AT&T also requires competitive carriers to sign on for a five-year term in order to be eligible for a 50% discount.⁸⁷ Customers that fail to meet the minimum purchase requirements during the five-year term of the plan are also subject to significant termination penalties for each year of non-compliance. The threat of large termination penalties sharply reduces a customer's economic incentive to move traffic off AT&T's network.

Exclusionary contract terms also have the effect of deterring service providers from building out their own facilities. Verizon, for example, has initiated a new pricing

⁸³ *Id.* § 22.20.4(D), at p. 22-125. Even with a 50% discount, AT&T's rates remain much higher than its cost of providing service.

⁸⁴ Unlike traditional volume discounts that exist in competitive markets, AT&T's discounts are not based on its own cost structure (*i.e.*, the savings it realizes by providing services in bulk). For example, an AT&T customer with \$10 million in total annual special access purchases would have to purchase \$9.5 million worth of those requirements (95%) in order to be eligible for the "volume" discount. Another AT&T customer, with a \$100 million in annual purchases, would have to purchase \$95 million worth of services to obtain the same percentage discount. Thus, AT&T's discount plan appears to be driven more by a desire to limit its customers' purchases from competing providers than by the savings involved in serving larger volume customers.

⁸⁵ Ameritech Tariff Transmittal 1369, § 22.20.3(C), at p. 22-123 (Nov. 18, 2003).

⁸⁶ *Id.* § 22.20.7, at p. 22-131 (Nov. 18, 2003).

⁸⁷ As noted above, AT&T's baseline rates are so high, that even a 50% discount does not bring the prices down to those that would exist in a competitive market.

plan⁸⁸ that offers discounts to carriers only if they agree to commit to purchase, for example, both 90% of their channel termination volumes as well as 90% of their transport volume. It is unlikely that a carrier would find it economical to construct its own low volume channel termination circuits. By tying the discount for channel terminations to a carrier's purchase of channel mileage, Verizon's plan provides an additional deterrent to the carrier's construction of its own interoffice transport facilities. Such practices plainly undermine the FCC's goal of encouraging facilities-based competition.

IV. SPRINT NEXTEL REMAINS ALMOST COMPLETELY DEPENDENT ON INCUMBENT LECs – ESPECIALLY THE BOCS – FOR ITS SPECIAL ACCESS NEEDS

In adopting Phase II pricing flexibility, the Commission explained:

The triggers we adopt for Phase II flexibility are sufficient to ensure that incumbent LECs cannot exercise any remaining monopoly power indefinitely. If an incumbent LEC charges an unreasonably high rate for access to an area that lacks a competitive alternative, that rate will induce competitive entry, and that entry will in turn drive rates down.⁸⁹

Contrary to this predictive judgment, Sprint Nextel is more dependent on the incumbent LEC (in the vast majority of cases, a BOC) for DS1 and DS3 channel terminations and channel mileage today than at the advent of pricing flexibility. For example, in 2001, 88% of the DS1 circuits and 74% of the DS3 circuits Sprint purchased for its wireline business in the top 50 MSAs were obtained from the incumbent LEC. By 2006, those numbers had risen to over 96% and over 84%, respectively.⁹⁰

⁸⁸ Verizon's National Discount Plan, Verizon FCC Tariff No. 1, § 25.3 and Verizon FCC Tariff No. 11, § 25.2 (issued May 25, 2007; effective June 9, 2007; found in base tariffs filed Aug. 6, 2007).

⁸⁹ *Pricing Flexibility Order* ¶ 144.

⁹⁰ See Lindsey Decl. ¶ 8.

Overall, for both its wireline and wireless businesses, Sprint Nextel relied on incumbent LECs' special access services for 96.4% of all DS1 and DS3 customer terminating circuits (including circuits terminating at cell sites) in the top 50 MSAs in 2006, including services for which incumbent LECs have been granted pricing flexibility as well as services for which incumbent LECs are still subject to price caps. The breakdown of the 96.4% figure across services and products for Sprint Nextel in 2006 is as follows:⁹¹

- 97% of all DS1s were purchased from the incumbent LEC;
- 88.4% of all DS3s were purchased from the incumbent LEC;
- In Phase I price flexibility areas:
 - 96.9% of all Sprint Nextel's DS1s were purchased from the incumbent LEC;
 - 88.7% of all Sprint Nextel's DS3s were purchased from the incumbent LEC;
- In Phase II price flexibility areas:
 - 97.2% of all Sprint Nextel's DS1s were purchased from the incumbent LEC;
 - 88.6% of all Sprint Nextel's DS3s were purchased from the incumbent LEC.⁹²

Even in large urban areas, Sprint Nextel remains dependent on incumbent LEC special access to meet its DS1 and DS3 needs. For example, in 2006, 98% of Sprint Nextel's DS1 and DS3 circuits in Chicago were purchased from AT&T; 97% of Sprint Nextel's DS1 and DS3 circuits in Boston were purchased from Verizon; and 99% of Sprint Nextel's DS1 and DS3 circuits in San Francisco were purchased from AT&T.⁹³

⁹¹ For purposes of this analysis, MCI and legacy AT&T are treated as incumbent LECs in Verizon and AT&T regions, respectively.

⁹² Lindsey Decl. ¶ 9.

⁹³ *Id.* ¶ 10.

By contrast, Sprint Nextel's largest alternative access vendor ("AAV") currently accounts for only 1% of Sprint Nextel's total special access spending.⁹⁴

Sprint Nextel's efforts to obtain service from competing providers of special access service have not produced significant alternatives. In 2004, before merging with Sprint, Nextel sent a Request for Interest ("RFI") to 13 competing providers, soliciting bids for circuits connecting more than 1,500 cell sites and hubs in the New York metropolitan area.⁹⁵ Only four providers indicated they could serve any of the locations listed in the RFI, offering to provide service to a total of only 43 cell sites out of the over 1,500 listed in the initial request.⁹⁶ The fact that competitors bid on fewer than 3% of locations in a geographic market that is considered to be one of the most competitive in the nation belies any claims that competitive alternatives are readily available to special access customers. If nothing else, the past five years have demonstrated that the barriers to entry (*e.g.*, cost of infrastructure, zoning and rights-of-way complications, the difficulty in digging up streets and sidewalks) have severely limited competitive entry.

More recent attempts to pursue alternatives to incumbent LECs have met with a similar lack of success. In January 2007, Sprint Nextel asked 77 competitive providers whether they had facilities located at any of over 52,000 Sprint Nextel cell sites. The results showed only a *de minimis* presence of competitive providers at Sprint Nextel cell sites. Sixteen of the respondents reported that they had fiber facilities located at one or more of the cell sites. But these facilities reached only 569 cell sites – just over 1% of the

⁹⁴ *Id.* ¶ 11.

⁹⁵ 2005 Nextel Reply Comments at 17.

⁹⁶ *Id.*

cell sites included in the questionnaire.⁹⁷ In any event, the presence of competitive providers at Sprint Nextel cell sites does not mean that they are viable alternatives. As Gary Lindsey, Director of Access Solutions for Sprint Nextel explains in his attached declaration, “none of the responding AAVs had large enough footprints in any market so that Sprint Nextel could use the AAV’s on-net facilities for any meaningful level of competition for backhaul and still be able to optimize the use of its network in such market.”⁹⁸ As these results make clear, there are virtually no competitive alternatives to incumbent LEC special access services for the critical facilities needed to connect Sprint Nextel’s cell sites to the rest of its network.⁹⁹

Nonetheless, Sprint Nextel continues to look for alternatives to BOC special access. These efforts paid off recently when Sprint Nextel reached an agreement with FiberTower Corp. (“FiberTower”) to provide backhaul for Sprint Nextel’s 4G/WiMax service in seven of the approximately 30 markets where Sprint Nextel is rolling out 4G services.¹⁰⁰ Even in those seven markets, however, FiberTower will only be able to satisfy a portion of Sprint Nextel’s special access needs for its 4G services. Moreover, the announced FiberTower deal will only cover new 4G facilities Sprint Nextel is deploying as part of its planned network and *does not replace any existing special access services that Sprint Nextel obtains from incumbent LECs*. Thus, Sprint Nextel continues to be almost totally dependent on incumbent LECs for the DS1 channel terminations

⁹⁷ Lindsey Decl. ¶ 5.

⁹⁸ *Id.* ¶ 6.

⁹⁹ Sprint Nextel’s experience is consistent with GAO’s finding that “competitive alternatives for dedicated access are not widely available.” GAO Report at Highlights.

¹⁰⁰ See FiberTower News Release (Aug. 1, 2007), *available at*: <<http://www.firstavenet.com/corp/news-press-releases-080107.shtml>>.

servicing its cell sites and for the backhaul facilities needed to serve its existing CDMA, EVDO and iDEN customers.

In sum, Sprint Nextel continues to rely heavily on incumbent LECs – in most cases a BOC – for special access services. This fact simply confirms what the evidence of the excessive BOCs’ earnings and unreasonable pricing levels also show: the Commission’s existing rules have permitted the BOCs to obtain Phase II pricing flexibility in areas where they remain dominant in the provision of special access. As we now show, the adverse economic effects of these flawed rules have been substantial.

V. EXCESSIVE PRICES FOR SPECIAL ACCESS HAVE A DIRECT, ADVERSE IMPACT ON CONSUMER WELFARE

A. High Special Access Prices Harm Consumers

Special access costs are a major component of Sprint Nextel’s costs of providing wireless service. Special access constitutes, on average, approximately 33% of the monthly cost of operating a cell site.¹⁰¹ The pricing of special access, thus, has a direct and material effect on the retail prices paid by CMRS consumers. Furthermore, reasonable special access prices would contribute significantly to Sprint Nextel’s ability to improve the quality of its CMRS offerings by freeing up funds for the construction of additional cell sites and other network improvements. In addition, reduced special access rates would exert downward pressure on retail prices for wireless services and would help to move toward a more level playing field between independent wireless providers and those providers affiliated with a BOC.

Reasonable special access prices would benefit CMRS users, many of whom are residential consumers. Much of the explosive growth in CMRS usage over the past

¹⁰¹ Lindsey Decl. ¶ 7.

several years has been driven by the widespread popularity of wireless offerings among non-commercial users, especially younger Americans. Indeed, as the array of calling plans has proliferated, a small but increasing number of Americans have completely forgone wireline phones in favor of wireless.¹⁰² In addition, the majority of wireless customers generally (*i.e.*, including those who do not use wireless as their primary telephone line) are “residential” customers rather than “business” customers.

“Residential” use of wireless services, the growing reliance on wireless telephony by residential consumers, and the substantial impact of special access charges on the cost and quality of wireless services all lead to the conclusion that reducing special access prices to reasonable levels would produce substantial benefits for individual consumers.

Moreover, special access has an impact on a wide variety of services on which consumers rely on a day-to-day basis. In addition to being a critical input into CMRS services provided to consumers, special access services are also used every time a consumer uses an ATM, or swipes a credit or debit card to pay for goods and services, or uses any of the myriad of other services that require dedicated links between two locations. Thus, more efficient special access rates would benefit consumers in many ways, both direct and indirect.

¹⁰² *Implementation of Section 6002(b) of the Omnibus Budget Reconciliation Act of 1993, Annual Report and Analysis of Competitive Market Conditions with Respect to Commercial Mobile Services*, Eleventh Report, 21 FCC Rcd 10947, ¶ 205 (2006) (“7.8 percent of adults lived in households with only wireless phones in the second half of 2005, up from 5.5 percent in the second half of 2004, and 3.5 percent in the second half of 2003”); *see also* Stephen J. Blumberg and Julian V. Luke, “Wireless Substitution: Early Release of Estimates Based on Data from the National Health Interview Survey, July-December 2006,” at 1 (Center for Disease Control, rel. May 14, 2007), *available at*: <<http://www.cdc.gov/nchs/data/nhis/earlyrelease/wireless200705.pdf>> (estimating that at least 12.8% of American homes had only wireless telephones during the second half of 2006).

B. High Special Access Rates Retard Broadband Deployment

Special access costs directly affect the pace of Sprint Nextel's construction of the infrastructure required to support its EVDO and 4G broadband wireless services.¹⁰³ The growing demand for data services will increase the need for dedicated transmission services, leading to increasing demand for special access. Thus, the impact of high special access prices will be even greater as new wireless broadband services are deployed.

The benefits of lower special access rates would not be limited to just wireless consumers. Special access is a critical input for other communications services as well. According to the Organization for the Promotion and Advancement of Small Telecommunications Companies ("OPASTCO"), for example, prices for special access affect the availability of broadband services in rural areas in the United States because:

[h]igh costs and the lack of competition for backbone access in rural areas results in the majority of rural ILECs having only one connection to backbone facilities. . . . As large carriers continue to merge, the number of options for access to the Internet backbone that are available to rural carriers diminishes. Therefore, the Commission must

¹⁰³ See Written Testimony of Barry West, Sprint Nextel Corporation, Before the House Subcommittee on Telecommunications and the Internet, at 3-4 (Apr. 19, 2007), *available at*: <http://energycommerce.house.gov/cmte_mtgs/110-ti-hrg.041907.West-testimony.pdf> (explaining that the efforts of Sprint Nextel and others to bring the next generation of wireless broadband to consumers throughout the country are impeded by "a serious failure in the market for 'special access services' [which are] a "lynchpin to the success of a vibrant, competitive broadband marketplace"); *see also* Letter from The Honorable Edward J. Markey, Chairman, House Subcommittee on Telecommunications and the Internet, to Chairman Kevin J. Martin and Commissioners Michael J. Copps, Jonathan S. Adelstein, Deborah Taylor Tate, and Robert M. McDowell (May 23, 2007), *available at*: <http://markey.house.gov/index.php?option=com_content&task=view&id=2859&Itemid=46> ("Because all wireless carriers rely so heavily on special access connections today, and will do so to an even greater extent in the future as they deploy next-generation broadband networks, I believe it is imperative for the Commission to modify its pricing flexibility rules for special access.").

remain vigilant to ensure that rural ILECs have affordable access to backbone facilities on nondiscriminatory terms.¹⁰⁴

Time Warner Telecom has explained that there is “evidence that ILECs are exploiting their control over bottleneck end user connections to control the pace at which competitors roll out next-generation facilities, thereby frustrating the goals of Section 706,” which mandates the deployment of “advanced” services to all Americans.¹⁰⁵ Meaningful special access pricing reform could therefore lead to faster and more widespread deployment of broadband services nationwide.

VI. MARKETPLACE DEVELOPMENTS SINCE 2005 HAVE ENTRENCHED THE DOMINANCE OF THE LARGEST BOCS

Recent mergers have intensified the already urgent need for special access reform. The SBC/AT&T and Verizon/MCI mergers eliminated not only two of the BOCs’ leading in-region competitors in the provision of telecommunications services, particularly to large and medium-sized business customers, but also the two leading alternative providers of dedicated DS1 and DS3 transmission links along certain routes in what are today AT&T and Verizon in-region territories. MCI and AT&T collectively accounted for 21% of Sprint Nextel’s DS1 purchases from alternative access vendors and 19.4% of its DS3 purchases from alternative access vendors in the top 50 MSAs.¹⁰⁶ Moreover, the new AT&T has discontinued services legacy AT&T formerly offered in its region.¹⁰⁷

¹⁰⁴ Comments of OPASTCO, GN Docket No. 07-45, at 10-11 (May 16, 2007).

¹⁰⁵ Comments of Time Warner Telecom, Inc., GN Docket No. 07-45, at 11-12 (May 16, 2007).

¹⁰⁶ Lindsey Decl. at 5 n.3.

¹⁰⁷ See, e.g., Public Notice, “Comments Invited on Application of SBC Long Distance, LLC d/b/a AT&T Long Distance to Discontinue Domestic Telecommunications Services,” 22 FCC Rcd 6613 (2007); Public Notice,

The mergers also provided AT&T and Verizon substantial advantages in their efforts to serve large and medium-sized businesses. Before the mergers, Sprint Nextel competed on an equal footing with AT&T and MCI because all three carriers paid the same inflated special access charges that are a key element in serving large and medium-sized businesses. The mergers not only gave AT&T and Verizon an immediate, substantial presence in this market segment, but also converted the special access charges assessed to their long distance operations into an internal intra-company transfer. In effect, the cost of special access services provided to AT&T and Verizon affiliates that serve large and medium-sized businesses is the actual economic cost of those services.¹⁰⁸ For example, AT&T now self-provisions a significant portion of special access services to AT&T Mobility, making that substantial component of AT&T Mobility's costs a mere accounting transfer between two AT&T affiliates. In contrast, the cost of those special access services to Sprint Nextel and other unaffiliated providers is the unreasonable charges that AT&T and Verizon assess.

The conditions that AT&T and Verizon accepted as part of the various merger proceedings plainly do not rectify the excessive levels of special access rates, most fundamentally because they are not intended to address the underlying market failure. Rather, they attempt primarily to provide a temporary, and extremely brief, respite from additional, future harm. Even in the short term, however, these temporary merger conditions provide little actual relief.

"Comments Invited on Application of BellSouth Long Distance, Inc. d/b/a AT&T Long Distance Service to Discontinue Domestic Telecommunications Services," 22 FCC Rcd 5600 (2007).

¹⁰⁸ That AT&T and Verizon must impute these access charges to their wireless and interexchange entities is irrelevant, because imputation affects only the part of their company in which they record the expense.

The AT&T/BellSouth merger conditions, for example, merely require AT&T for 39 months after the merger closing date to apply rates no higher than its price cap tariffed rates to those of its DS1 and DS3 channel termination services, DS1 and DS3 mileage services and Ethernet services that are otherwise subject to Phase II pricing flexibility.¹⁰⁹ They also require a 15% reduction in the tariffed rates for Ethernet services for the same period.¹¹⁰ AT&T, of course, will be free to raise its Phase II rates back to pre-merger levels or higher as soon as the 39-month term expires.

The benefits of the Verizon/MCI merger special access pricing conditions were even more modest, requiring only that Verizon's incumbent LECs not increase the already-inflated rates in Verizon's interstate tariffs for special access services that Verizon provides in its in-region territory for 30 months after the merger closing date.¹¹¹ These modest rate freezes are scheduled to expire by July 2008, less than one year from now.¹¹² In short, merger conditions provide only temporary, limited relief from ongoing increases in special access prices and do nothing to rectify the inflated rates Verizon and MCI continue to charge, or to erode those BOCs' dominance in the provision of special access.

Supporters of the mergers have vigorously touted the efficiencies produced by the proposed transactions,¹¹³ and the approvals of the mergers have been premised, in part,

¹⁰⁹ *AT&T/BellSouth Merger Order*, Appendix F; *AT&T/BellSouth Merger Recon Order*, ¶ 5 (2007).

¹¹⁰ *AT&T/BellSouth Merger Order*, Appendix F.

¹¹¹ *Verizon/MCI Merger Order*, Appendix G.

¹¹² *Id.*

¹¹³ *SBC Communications Inc. and AT&T Corp. Applications for Approval of Transfer of Control*, WC Docket No. 05-65, Description of the Transaction, Public Interest Showing, and Related Demonstrations at 44 (Feb. 22, 2005) (estimating net

on the recognition of the cost synergies they would generate.¹¹⁴ If the mergers have produced the asserted efficiencies, however, the merged BOCs have not passed through those efficiency gains in the form of lower prices for special access. In a competitive market, efficiency gains would be shared with customers.¹¹⁵ Yet, because the special access market is not competitive and because AT&T and Verizon have strong incentives to impose the highest costs on their competitors that the FCC will tolerate, any efficiencies produced by the mergers have not been shared with special access customers. In sum, the mergers have eliminated competitors from the market and the much-heralded efficiencies achieved by the mergers have not been passed along to consumers.

VII. COMPREHENSIVE REFORM OF THE COMMISSION'S REGULATION OF THE BOCs' SPECIAL ACCESS SERVICES IS IMPERATIVE

In 1990, when the Commission adopted incentive regulation for the BOCs, special access revenue was \$2.5 billion, less than 13% of the BOCs' overall interstate telecommunications revenues.¹¹⁶ Today, BOC special access revenue has ballooned to \$15.6 billion and represents more than 51% of the BOCs' interstate telecommunications

present value of synergies at \$15 billion); *Verizon Communications Inc. and MCI, Inc. Applications for Approval of Transfer of Control*, WC Docket No. 05-75, Public Interest Statement at 15 (March 14, 2005) (estimating \$7 billion in incremental revenues and operational cost savings); *AT&T Inc. and BellSouth Corporation Application for Transfer of Control*, WC Docket No. 06-74, Description of Transaction, Public Interest Showing and Related Demonstration at 52 (March 31, 2006) (estimating \$18 billion in total synergies).

¹¹⁴ *SBC/AT&T Merger Order* ¶¶ 201-204; *Verizon/MCI Merger Order* ¶¶ 211-212, 214; *AT&T/BellSouth Merger Order*, ¶¶ 221, 224.

¹¹⁵ See GAO Report at 6.

¹¹⁶ 1990 FCC ARMIS Report 43-01, Table 1 – Cost and Revenue, Row 1090, comparing special access revenue in Column (s) to interstate revenue in Column (h).

revenue.¹¹⁷ In view of the overwhelming evidence that the BOCs remain dominant in the provision of special access, this dramatic growth in revenues underscores the need for the Commission to reinstate incentive regulation of the BOCs' special access service offerings. The BOCs' dominance in the special access market is well-established, as are the harms caused by their exercise of their market power. In particular, high special access prices raise the costs of CMRS and wireless broadband services, as well as other services used by consumers and enterprise customers. Accordingly, the Commission should not hesitate to act to rectify the harms caused by unconstrained special access prices.

The Commission's reform of the current special access regime should have both short-term and longer-term elements. In the near term, the special access rates that are most urgently in need of reform are those assessed by AT&T and Verizon, both because they are by far the largest providers of special access and because they are also the largest providers of commercial wireless services. The Commission, therefore, as an initial matter should require Verizon to reduce its Phase II pricing flexibility rates for special access services to levels that are no higher than the tariffed rates (and on the same terms and conditions) that apply to similar services in areas where those BOCs are subject to price caps, and it should eliminate the time limit that currently applies to AT&T's similar action in connection with the AT&T-BellSouth merger. In view of the demonstrated flaws in the current rules, the FCC should also immediately eliminate Phase II pricing flexibility for AT&T and Verizon, and place all of the affected special access services under price caps. Finally, the Commission should move their price indices for special

¹¹⁷ 2006 FCC ARMIS Report 43-01, Table 1 – Cost and Revenue, Row 1090, comparing special access revenue in Column (s) to interstate revenue in Column (h).

access toward more reasonable levels by reducing the indices to the levels that would have been in effect if AT&T and Verizon had been required to apply an X-Factor of 5.3% in connection with the annual access tariff filings of 2004, 2005, 2006, and 2007.¹¹⁸ Beginning in July 2008, the Commission should require them to use an X-Factor of 5.3% on a going-forward basis, pending the Commission's adoption of an updated factor.

Over the longer term, the Commission finally should carry out its pledge to move access prices to economically efficient levels.¹¹⁹ Market forces have not done so for the past eight years and will not do so in the foreseeable future. In addition, a longer-term reform plan should include a more current estimate of the BOCs' annual productivity gains that exceed those of the economy as a whole as well as reliable, administratively workable criteria for assessing the presence of alternative providers of special access services along point to point routes.¹²⁰ Such a long-term regime of incentive-based, price cap regulation for special access is the only means of ensuring that the charges for those services remain at reasonable levels and the BOCs are not prematurely given pricing flexibility.¹²¹

¹¹⁸ The 5.3% figure is the X-Factor most recently prescribed by the FCC and upheld by the D.C. Circuit. See *Price Cap Performance Review for Local Exchange Carriers*, First Report and Order, 10 FCC Rcd 8961, 9054-58 (1995), *aff'd sub nom. Bell Atlantic Tel. Cos. v. FCC*, 79 F.3d 1195, 1201, 1208 (D.C. Cir. 1996).

¹¹⁹ See, e.g., *Access Charge Reform*, First Report and Order, 12 FCC Rcd 15982, ¶¶ 43, 48 (1997) (implementing rate restructuring to move access charges toward their forward-looking cost levels, and reserving the right "to adjust rates in the future to bring them into line with forward-looking costs" where competition did not emerge); *CALLS Order* ¶ 57 (providing price-cap LECs a choice between the interim rate-level components of the CALLS plan, or having their rates reinitialized based on forward-looking economic costs).

¹²⁰ Nextel, for example, previously suggested that the Commission could use the same triggers for purposes of this special access analysis that it adopted for assessing "impairment" under section 251(d)(2)(B). 2005 Nextel Comments at 22-24.

¹²¹ At a minimum, for the reasons described above, the Commission should require the two largest BOCs to comply with this latter requirement.

VIII. CONCLUSION

The record in this proceeding overwhelmingly demonstrates that neither competition nor government action has disciplined the BOC's' ability to maintain or increase their supra-competitive special access prices and to demand anticompetitive terms and conditions from their customers. The Commission must act immediately to constrain the BOC's', and in particular AT&T's and Verizon's, market power. As the record overwhelmingly has demonstrated already, failure to do so will harm both consumers and competition.

Respectfully submitted,



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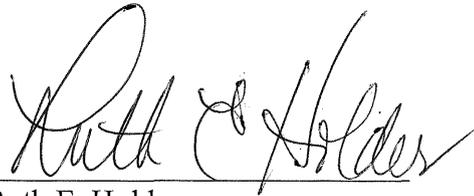
August 8, 2007

Certificate of Service

I, Ruth E. Holder, hereby certify that on this 8th day of August, 2007, I caused true and correct copies of the foregoing Comments of Sprint Nextel Corporation, with attachments, to be mailed by electronic mail to:

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Ruth E. Holder