buildings from splice points in their fiber transport rings, (*see TRRO* ¶ 153) which may be many miles away from the closest end-office in which the carrier has collocated.

Fourth, the triggers include no mechanism for reviewing the extent to which collocators continue to compete in an MSA. Once an ILEC demonstrates that it has met a trigger in an MSA, it is freed from regulation in the future even if the collocators upon whom it relied to meet the triggers exit the market or are acquired by the ILEC itself. This is obviously highly relevant now that AT&T and Verizon have acquired legacy AT&T and MCI, the two carriers that likely had more fiber-based collocations than any other competitors.

B. In Adopting The Special Access Pricing Flexibility Triggers, The Commission Relied On Assumptions That Have Since Been Disproven.

Despite some misgivings regarding the accuracy of its triggers, the Commission was willing to establish its pricing flexibility framework based on several assumptions regarding the nature of the special access market and regulations. These assumptions, however have since proven to be incorrect. Most importantly, the Commission assumed that special access inputs would be most crucial to IXCs, not CLECs: "[W]e note that these services generally are purchased by IXCs." *Pricing Flexibility Order* ¶ 155. *See also id.* ¶ 142. The Commission did not even consider the possibility that competitive providers of local exchange and special access services would themselves purchase loops and transport from ILECs under special access tariffs. In explaining why ILECs would be unlikely to exploit pricing flexibility to discriminate unreasonably among special access customers, the Commission emphasized that IXCs are large businesses that purchase special access and "generate significant revenues for the incumbent and are not without bargaining power with respect to the incumbent." *Id.*

Moreover, the FCC also assumed that ILECs would sell special access to competitors only in markets where the ILECs' own downstream retail offerings were subject to separate affiliate requirements.[36] Throughout the *Pricing Flexibility Order*, the Commission referred to ILEC in-region long distance offerings as provided through "affiliates" (*see, e.g., id.* ¶¶ 129, 134-35). The FCC even established special protections against ILEC price discrimination in the provision of special access that are only relevant where the ILEC provides retail service through a separate affiliate.[37] Of course, no such protections apply in the local and special access markets in which ILECs provide service on an integrated basis. This is of course precisely the context in which competitors like TWTC and One Communications purchase special access from ILECs.

More fundamentally, in adopting its pricing flexibility rules, the Commission relied on the key assumption that incumbent LECs would not be able to sustain price increases in areas in which competitors have established fiber-based collocations because the competitors would simply expand their entry to undercut the incumbents' prices. But this assumption is clearly incorrect, especially with respect to high capacity loops. As explained, competitive deployment of last mile facilities has been minimal, and as explained below, ILEC prices are well above the level that would be expected in a competitive marketplace.

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

[37] *See id.*¶ 129 (prohibiting an ILEC from offering a contract tariff to an affiliate unless and until an unaffiliated customer first purchases service pursuant to the contract).

Accordingly, contrary to the Commission's assumption in the pricing flexibility order,[38] competitive carriers cannot quickly increase supply to counter high ILEC special access prices. In other words, the combination of very high entry barriers and low competitive carrier capacity means that the elasticity of supply for high capacity loops is extremely low, enhancing the ILEC's market power.

There is no clearer illustration of the ILECs' ability to sustain high prices without risking significant market share loss that Qwest's special access price increases in 2004. .[39] As a result of those increases, TWTC's prices for special access in Qwest's region increased by approximately 19 percent. Unsurprisingly, the increases were greatest for DS1 facilities which are the least likely to face competitive supply. For example, TWTC faced rate increases of nearly 25 percent for rates applicable to DS1 channel terminations in "the most competitive" zone 1 as well as for rates applicable to 0-8 mile mileage DS1 transport. Notwithstanding these price increases, neither TWTC nor any other competitor has been able to accelerate its deployment of local transmission facilities in the Qwest region. There is no clearer illustration of ILEC market power.[40]

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[38] *Id.* ¶ 144 ("If an incumbent LEC charges an unreasonably high rate for access to an area that lacks a competitive alternative, that rule will induce competitive entry, and that entry will in turn drive rates down.").

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

[40] *See Noel D. Uri & Paul R. Zimmerman, Special Access Services and its Regulation in the United States,* 6 J. OF POLICY, REGULATION, AND STRATEGY FOR TELECOMMUNICATIONS, 127 (2004) ("Market Power is the ability of a LEC to sustain prices above the competitive level for an extended period of time without significant loss in customers. Market power can be inferred when a firm is able to implement a price

In sum, given the flaws in these triggers, it is unsurprising that they are terrible predictors of the presence of competition within an MSA. As the GAO concluded, the FCC was wrong in its predictive judgment that its triggers would accurately estimate those areas where competition was sufficient to restrict ILEC market power, has been wrong.[41] To the contrary, "[t]he data . . . show that the theoretically more competitive Phase II areas generally have a lower percentage of lit buildings than phase I areas." GAO Report 12-13. Clearly, the pricing flexibility triggers do not capture where competitive deployment has actually occurred.

C. The Commission's Price Cap Regime For Special Access Is Flawed

The Commission's price cap rules governing special access services are themselves insufficient to constrain ILEC exploitation of their market power over special access. The obvious problems derive from the flaws in the Commission's *CALLS Order*. In the CALLS plan, the ILEC participants (including all of the BOCs) agreed to establish a separate price cap basket for special access and to set a 6.5 percent X-Factor (net of inflation) for that basket. The Commission acceded to this commitment without any modifications.

Unfortunately, in so doing, the Commission agreed to two components of the special access regulatory regime set forth in CALLS that were obviously flawed. One

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increase absent a significant increase in costs or quality. *This sort of evidence is especially indicative when the prices that are high and rising relative to economic costs fail to attract new competitors or when entry into the market remains essentially foreclosed.*") (emphasis added) ("*Uri & Zimmerman*").

[41] GAO Report at 42 ("[O]ur analysis of facilities-based competition suggests that FCC's predictive judgment — that MSAs with pricing flexibility have sufficient competition — may not have been borne out, particularly for channel terminations to the end users of dedicated access.").

problem was that, under the plan, the X-Factor was discontinued as of the ILEC access tariff filings on July 1, 2004. From that date on, the X-Factor for the special access basket equaled inflation.[42] This policy seems to have been based on the Commission's assumption that competition would emerge to constrain ILEC special access prices and drive them down. *See CALLS Order* ¶¶ 36, 44 (describing CALLS as a transitional plan until competition develops sufficiently to control ILEC prices). As is now abundantly clear, this never happened.

The other problem with the manner in which the 6.5 percent X-Factor applied to the special access basket under CALLS is that, in the many MSAs in which ILECs received Phase II pricing flexibility prior to July 1, 2004, even the limited rate reductions required by the CALLS plan did not take full effect because Phase II MSAs are not subject to price caps at all. Yet, as is also now abundantly clear, the triggers for Phase II pricing flexibility are poor predictors of where competition is sufficient to constrain ILEC prices.

As a result of these limitations, the rate reductions required for the special access price cap basket by operation of the 6.5 X-Factor under the *CALLS Order* were insufficient to ensure that ILEC special access prices were brought within a zone of reasonableness. As the ILECs experienced higher and higher volumes of special access sales, and thus higher and higher economies of scale and scope, its prices were allowed to remain at their high levels. In real terms, the ILECs' prices increased dramatically during this time period, as the data regarding regulated rates of return demonstrate.

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[42] *See Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers*, Sixth Report and Order, 15 FCC RCd 12962, ¶ 149 (2000), *subsequent history omitted* ("*CALLS Order*").

D. The Commission Has Failed To Regulate ILEC Rates For Ethernet Service

While the FCC's regulatory regime has been fatally flawed with regard to services subject to pricing flexibility and price caps, it has been even worse for Ethernet services that were in some cases never or only recently subject to price caps.

As an initial matter, it is important to note that the FCC's public notice implies that Ethernet and other packetized transmission services are "unregulated" and do not qualify as special access services.[43] This is simply not the case. The FCC has repeatedly classified packetized transmission services as special access services, nearly all such services are now subject to the special access pricing flexibility regime, and, with the exception of Verizon's packetized services, are subject to full Title II regulation. For example, in recently granting Qwest pricing flexibility for its Metro Optical Ethernet Service, the FCC held that "good cause exists to permit Qwest to exercise pricing flexibility for advanced services that rely on packet technology, similar to the pricing flexibility relief that it has for *other special access services*."[44] Clearly, the FCC believed that Qwest's Ethernet service was simply another type of special access service regulated under Title II. Indeed, the order granted a waiver to Qwest of rules 1.774, 69.709, 69.711, and 69.727 applicable to common carrier special access services so that Qwest

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[43] *See Public Notice,* at 2 (rel. July 9, 2007) ("To assist in the assessment of the reasonableness of rates for special access services, we ask parties to supplement the record with information on vendor prices for high capacity transmission equipment, outside plant, fiber, and fiber installation, and on prices for nonregulated services that provide similar or equivalent capabilities to special access services, such as Ethernet and packet-based services.").

[44] *Qwest Petition for Waiver of Pricing Flexibility Rules for Advanced Communications Networks Services*, Order, 22 FCC Rcd 7482, ¶ 5 (2007) (emphasis added) ("*Qwest Price Flex Order*"); *Id.* ¶ 7 ("These advanced services are special access services...").

could keep its Metro Optical Ethernet Service outside of price caps while still obtaining the benefits of pricing flexibility. *See id.* n.20. Moreover, Qwest itself has recently argued that its packetized services, like Verizon's, are in fact special access services.[45]

Despite the fact that packetized special access services remain regulated under Title II, for years, the FCC has treated many packetized and specifically Ethernet services as outside of price caps. Regulation actually varied by BOC. For example, BellSouth received pricing flexibility for its packetized services essentially by accident in 1996. As the FCC explained, because BellSouth included the contested packet-switched services in price caps in its 1996 annual price cap tariff filing pursuant to Section 61.42(g) and the services were subject to the Bureau's scrutiny, the Commission concluded that BellSouth's packet-switched services were properly "regulated under price caps" and thus "were eligible for pricing flexibility."[46] Packetized services sold by SBC's advanced services affiliate became eligible for price caps in 2002.[47] Just this year, the FCC granted AT&T pricing flexibility for its OPT-E-MAN Ethernet service which had not been sold

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[45] *Id. at* n.25 (*citing* Qwest Petition for Waiver of Pricing Flexibility Rules for Advanced Communications Networks Services, WC Docket No. 06-187, at 2 (filed Sept. 22, 2006) ("explaining that, like Verizon's packet-based advanced services, Qwest's advanced services are special access services because they use "dedicated facilities that enable an end-user customer to connect two or more of its locations.") (citations omitted)).

[46] *See BellSouth Petition for Pricing Flexibility for Special Access and Dedicated Transport Services,* Memorandum Opinion and Order, 16 FCC Rcd 18174, ¶ 15 (2001).

[47] *See SBC Communications Inc., Petition for Waiver of Section 61.42 of the Commission's Rules,* Order, 22 FCC Rcd 7224, ¶ 3 (2007) ("In 2002, the Commission relaxed pricing restrictions for AT&T by forbearing from tariff regulation of its advanced services in areas then served by SBC on the condition that it provide these services through a separate affiliate. This allowed AT&T to exercise pricing flexibility for these services by offering them through its affiliate, Advanced Solutions, Inc. (ASI), rather than through its LECs.") (citations omitted).

through its advanced service affiliate.[48] Importantly, AT&T's OPT-E-MAN Ethernet Service and Qwest's Metro Ethernet Service, continue to be offered *outside of price caps* even though the FCC has granted pricing flexibility for these services.[49] Therefore, many Ethernet services were *never* subject to X-Factor driven rate reductions over the many years when the X-Factor was set above inflation. This is the central reason why ILEC tariffed Ethernet rates are priced at such exorbitantly high levels and why, as described below, even "discounted" Ethernet services are too expensive to permit TWTC to rely on them as inputs for TWTC's retail services.

IV. ILECS HAVE USED THEIR MARKET POWER AND FREEDOM FROM REGULATION TO SET SPECIAL ACCESS RATES AT SUPRACOMPETITIVE LEVELS

As a result of their market power over local transmission facilities, the lack of intermodal alternatives and ineffective rate regulation, the ILECs have charged exorbitant rates for special access. Even the ILECs admit that their month-to-month tariff rates are extremely high. Yet they argue that few customers pay these rates, because customers can-opt into discount plans. This point is both true and unconvincing since the discounted prices are still well above what competitors charge in the few instances where

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[48] *See id.* ("AT&T, however, also offers some advanced services through its LECs that do not qualify for the 2002 forbearance relief. Accordingly, with this petition, AT&T seeks authority to place into price caps those packet-switched services that its LECs offered outside of price cap regulation, so that these services could subsequently qualify for pricing flexibility. Specifically, AT&T requests the ability to exercise pricing flexibility for its Optical Ethernet Metropolitan Area Network (OPT-E-MAN) service, which it offers through its LECs, and for new packet-based advanced services that it may offer through the AT&T LECs in the future.") (citations omitted).

[49] *See id.* n. 30 ("As an initial matter, we find it unnecessary for AT&T's LECs in areas formerly served by SBC to incorporate these services into price caps before they are eligible for pricing flexibility."); *see also Qwest Price Flex Order* n. 20.

competitive alternatives are available and, as explained in the next section, the discounted offers are available only to purchasers who make commitments that effectively preclude the development of wholesale competition.

ILECs offer three basic types of discount plans: (1) "Term" discounts that require no monetary or circuit commitment, but generally offer the smallest discount and often lack key benefits such as circuit portability; (2) "Standard" discounts that are available to any qualifying purchaser, that generally require a minimum circuit commitment level, and that apply to both Phase II and price cap rates[50] and (3) "Overlay" discounts that are individually negotiated with a particular purchaser and then filed as contract tariffs. Overlay tariffs provide small discounts that apply to Phase II rates on top of any "Standard" or "Term" discounts. Despite these discounts, ILEC rates are almost universally higher than UNE rates, and are often two times higher than most competitive wholesale providers' (including TWTC's) rates in both Phase II and price cap areas, especially for circuits with any interoffice mileage. If the special access market were truly competitive, this price differential simply would not exist.

A. ILEC Prices For Special Access Are Higher In Phase II MSAs Than In MSAs That Remain Subject To Price Caps

The increase in special access rates under pricing flexibility has been studied and documented in excruciating detail. As early as 2004, FCC economists Paul R.

[50] Certain carriers, only offer term plans for certain elements. For example, AT&T (in its former BellSouth and SBC regions) only offers a term discount plan for DS3; there is no "Standard" discount.

Zimmerman and Noel Uri conducted an extensive study of ILEC special access pricing practices. In their study, Zimmerman and Uri explained that, while special access provided only a 7.4 percent rate of return to the ILECs in 1996, this had climbed to 37.1 percent in 2003. *See Uri & Zimmerman* at 126. They also found that ILEC special access revenues nearly quadrupled from $3.1 billion in 1996 to $12 billion in 2002. *See id.* Over this same time period, special access lines grew as a percentage of all access lines from 8.9 percent to 41 percent. *See id.* As Messrs Zimmerman and Uri noted, it runs counter to economic theory that prices would continue to rise as output increases in a market (such as special access) characterized by substantial economies of scale and scope.[51] The only reasonable inference is that the special access market is not competitive. *See id.*

In addition, by scrutinizing DS1 and DS3 channel mileage and termination rates (not merely rates of return), Zimmerman and Uri were able to determine that rates under pricing flexibility increased substantially for almost every BOC, in almost every pricing flexibility market for both month-to-month offerings as well as for rates subject to long term commitments. *Id.* at 156-7. They concluded that "LECs subject to price caps who have been granted pricing flexibility have taken advantage of the opportunity...To a greater or lesser degree, depending on the individual LEC, rates have been raised by LECs in an environment where these LECs are already earning rates of return substantially in excess of what they would earn in a competitive market." *Id.* at 157.

[51] *See Uri & Zimmerman* at 157 ("In a competitive market where demand for special access service is growing, as characterized by the growth in special access revenue, this should result in the rates actually falling. The fact that no rates have declined and that many have increased is further evidence that the price cap LECs are exercising market power and that the market for special access service is not competitive.").

The GAO has reached similar conclusions regarding the failure of the pricing flexibility regime to constrain ILEC market power. As the GAO concluded, list prices in Phase II areas "are higher than average list prices in phase I and price-cap areas." *GAO Report* at 13.

Furthermore, special access purchasers have already placed substantial evidence on the record in this proceeding demonstrating that month-to-month and term tariff rates have nearly universally increased in Phase II areas to levels higher than is the case in price cap markets. In its study of RBOC rates, WilTel concluded that "the pricing of channel terminations in pricing flexibility areas substantially exceeds price cap pricing for virtually all ILECs and contract terms investigated." *Wiltel Reply* at 19. Global Crossing has demonstrated that DS1 channel termination rates are 22 to 47 percent higher in Qwest Phase II areas than price cap areas while DS1 mileage rates are 13 to 71 percent higher in BellSouth Phase II areas than price cap areas.[52]

[proprietary begin] [proprietary end] This would simply not be the case if competition were truly pushing down prices in those Phase II areas allegedly subject to competition.

B. ILEC Discounted Prices Are At Least 2-3 Times Higher Than Prices Charged By Competitive Wholesale Providers Of Special Access Service

Even the prices ILECs offer under their Standard and Overlay discount plans are well in excess of competitive wholesale prices; often two to three times as high and

[52] *See* Reply Comments of Global Crossing et al., WC Dkt. No. 05-25 at 7 (filed July 29, 2005).

sometimes even more for circuits with substantial mileage.[53] This is true with regard to both TDM and Ethernet services and in price cap as well as Phase II markets.

To begin with, as Broadwing has observed, competitive wholesalers offer shorter contract terms (generally one year) and do not have minimum volume commitments. *See* Broadwing Comments at 26-27. **[proprietary begin] [proprietary end]**

DS1 and DS3 Pricing. Even when all available discounts are taken into account, TWTC must pay the ILECs monopoly rates in nearly every market they compete. The charts below compare average competitive wholesale prices, including TWTC's prices to ILEC prices per element in "zone 1" averaged over all the states where TWTC purchases service in a BOC region. Zone 2 and 3 areas exhibit substantially higher prices. **[proprietary begin] [proprietary end]** Finally, the charts below also provide average UNE prices TWTC pays across the relevant BOC region. **[proprietary begin]**

[proprietary end] It is important to emphasize that many carrier customers pay special access rates far in excess of the rates TWTC pays. **[proprietary begin]** **[proprietary end]** As the charts attached hereto as Appendix B indicate, the penalty for not signing up for the longest available term or discount plan can be substantial. *See* Appendix B.

OCn Service. ILECs retain pricing power over OCn level services as well. Although CLECs are generally able to provision OCn circuits more easily than DSx

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[53] This is what former FCC economist Joseph Farrell foresaw when he stated that, "[w]hen the basic month-to-month plan specifies prices significantly above the competitive level, these discounted prices (and discounted prices in other plans) can also be above competitive levels." Reply Declaration of Joseph Farrell ¶ 4, attached to reply comments of CompTel *et al.*, WC Dkt. No. 05-25 (filed July 25, 2005) ("*Farrell Reply Decl.*").

circuits because of the increased revenue opportunity, there are still many buildings for which the ILEC is the sole provider of OCn on-net connectivity. As the GAO found, less than 25 percent of buildings demanding 2-DS3s *or more* of traffic are served by competitors. It is therefore economically rational for ILECs to increase the price of OCn circuits to monopoly levels even though they may lose some customers in those few buildings where competitors are present and offer lower prices.

High OCn rates are compounded by the fact that ILECs generally do not offer discount plans for such services. The result is extremely high ILEC prices, particularly in markets no longer subject to price cap regulation. Competitive wholesale prices for OCn services are much lower in nearly all cases. **[proprietary begin] [proprietary end]**

Qwest OC-3 (1 Year)

	0 Mile	5 Mile	10 Mile
Price Cap	3578.66	4063.66	4548.66
Phase II	6510	7235	7960

[proprietary begin]

[proprietary end]

Ethernet service. ILEC "discounted" Ethernet prices are also well in excess of competitors' wholesale rates. **[proprietary begin] [proprietary end]**

C. ILEC Pricing Practices In Long Haul Markets Illustrate Their Pricing Practices In Competitive Markets.

High prices for ILEC local services stand in marked contrast to ILEC prices for long haul transmission services. In markets like long-haul where ILECs do not have market power, their prices are, in line with competitors. Those services share many of

the basic technical characteristics of local transmission. But, on long-haul transmission routes where competition is ubiquitous, prices have fallen more than 90 percent since 1999.[54]

ILECs' as well as competitors' long haul rates have fallen in equal measure and are largely within the same pricing range . It is revealing that the ILECs' monthly charge for a DS3 channel termination, before any mileage charge component is added, is about the same as the monthly charge for a 1000 mile DS3 long-haul circuit. **[proprietary begin] [proprietary end]**

D. The ILECs' Reliance On Prices Per Voice Grade Equivalent Is Unpersuasive.

In an attempt to demonstrate that, contrary to all available evidence, special access rates have declined, the ILECs have argued that their average revenue per voice grade equivalent line ("VGE") (i.e. per DS0) has declined. But this is just a red herring.

Unsurprisingly, because VGEs are never sold in the real world, the revenue per VGE has little bearing on the price of actual special access services. Rather, the gradual decrease in ILEC revenues per VGE is simply a function of increased customer demand for capacity. As such demand increases, customers shift to higher bandwidth facilities.[55] These higher bandwidth facilities are, not surprisingly, less expensive on a per VGE basis. This is so because, as the FCC has recognized, the cost of increasing bandwidth is

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[54] *See, e.g., Comments of T-Mobile USA, Declaration of Simon J. Wilkie, WC Dkt. No. 05-25, RM-10593,* ¶ 12 (June 13, 2005) ("Consider the market for DS3 (45 Mbps) level transport from New York to Los Angeles, a distance of approximately 2,500 miles. In June 1999, such a circuit would be leased for $55,000. In February 2004, the price was $3,500 per month. This represents a decline of over 90 percent.").

[55] This dynamic is explained at length by economist Lee Selwyn. *See generally Selwyn Declaration, supra* note 13.

minimal compared to the fixed costs of laying the fiber in the first place.[56] Therefore, even though an OC-12 is equal to 336 DS-1s of capacity, prices for OC-12 circuits are much lower than 336 times the price for a DS-1. **[proprietary begin] [proprietary end]**

Importantly, increased demand for bandwidth yields lower ILEC revenue per VGE *even if the ILEC increases its prices*. As more customers buy more OCn services, the price per VGE falls regardless of the ILEC's prices. Because OC-12 circuits cost less on a VGE basis than a DS1, DS3 or OC-3, purchasers will switch to an OC-12 once the cost of multiple OC-3s exceeds the cost of a single OC-12. The fact that an OC-12 is, on a per VGE basis less expensive than a DS-1 or DS-3 is irrelevant to the fact that ILEC DS-1, DS-3 and OCn prices are set at a monopoly level and are increasing. It is easy to imagine a scenario in which an ILEC would increase all of its prices by the same amount over time while customers (with low price elasticity of demand, as is generally the case) require and purchase circuits of ever-greater capacity, with the result that the ILEC receives less revenue per VGE. Revenue per-VGE is therefore utterly irrelevant to the question of whether an ILEC has increased its prices or retained prices at monopoly levels.

V. HIGH ILEC SPECIAL ACCESS PRICES HARM CONSUMER WELFARE BY REDUCING THE SIZE OF COMPETITORS' ADDRESSABLE MARKETS

Not only do higher ILEC prices result in dead weight consumer welfare losses like any other monopoly rents collected by a dominant firm, they also have the longer

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[56] *See* TRO ¶ 312 ("Once the significant fiber construction cost is incurred, the record reflects that it is relatively easy and inexpensive to install fiber strands in excess of current demand at that time to maximize the use of the conduit and avoid the need to incur duplicate costs to retrench the same collocation in the future if demand for additional fiber facilities occurs.").

term effect of limiting the extent to which competitors can compete. This is because, even after applying all applicable discounts, ILEC prices are simply too high to permit competitive entry in many instances.

This is especially so for Ethernet services. ILECs demand that competitive carriers pay thousands of dollars for a 1 Gbps cross-connect facility in the ILECs' central offices if a wholesale purchaser wishes to transmit traffic between customer locations served by a purchaser's on-net Ethernet loops and special access Ethernet loops leased from the ILEC. **[proprietary begin] [proprietary end]**

In this way, high ILEC prices prevent TWTC from serving retail customers at locations to which it is not economical for TWTC to deploy its own facilities. As customers increasingly demand that their carriers serve a higher and higher percentage of their locations, TWTC's addressable market for Ethernet shrinks accordingly.

VI. THE ILECS HAVE ENGAGED IN EXCLUSIONARY PRICING PRACTICES TO PREVENT WHOLESALE COMPETITION IN THE PROVISION OF SPECIAL ACCESS FROM DEVELOPING.

The limited discounts offered by ILECs come at a substantial cost. In order to obtain such discounts, wholesale purchasers must knuckle under to unreasonable terms and conditions that bear no relationship to efficiencies yielded by volume or term commitments. These include minimum and escalating volume commitments to maintain the same discount, and explicit and *defacto* restrictions on buying from competitors and purchasing UNEs. These conditions leave competitors no choice but to both forgo purchasing from competitive wholesale suppliers in those few locations where such alternatives exist.

Despite these onerous terms and limited discounts, carriers like TWTC simply must sign up for them: it cannot afford ILEC month to month rates, it cannot build its

own facilities in many cases, and competitive wholesalers are simply not present at most locations. In this sense, these contracts often serve as anticompetitive tying arrangements--tying access to those circuits that are only available from the monopolist (the tying product) to the portion of the CLEC's demand that could be fulfilled by competitive providers (the tied product).

These discounts are structured to ensure that monopoly rates are maintained while keeping CLEC traffic on the ILECs' networks. Economic theory teaches that even a monopolist has an upper price limit. Above that price, the monopolist cannot force buyers to purchase services. Yet, the high month-to-month tariff rates are actually set *above* the monopoly price. Purchasers can obtain the monopoly price, which, as discussed above, is often two to three times higher than competitive wholesale rates, only by signing up for the discount plans. As former FCC Chief Economist Joseph Farrell has explained: "[W]hen a monopoly offers proportional or relative discounts off its undiscounted prices in order to induce customers to agree to exclusionary provisions, it has an incentive to set the undiscounted price above even the monopoly level (because rather than simply deterring demand, an increase above the monopoly level steers customers into the discount plans and also brings the discount prices closer to the monopoly level."[57]

A. ILEC Standard And Overlay Discount Offers Lock In CLEC Demand

The terms of ILECs' Standard and Overlay discount offers are extremely onerous and anticompetitive.[58] For example, AT&T's current Overlay contract with TWTC does

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[57] *See Farrell Reply Decl.* ¶ 4.

[58] A more detailed description of the discount plans are provided in Appendix C.

not permit TWTC to purchase more than a minimal number of UNEs. If TWTC fails to meet this condition, it loses the offered discounts.[59] TWTC's contract is not unique; numerous AT&T contract tariffs including the "MVP" plan contain a similar requirement.[60] The FCC found that 11 CLECs subscribed to the MVP plan in SBC's region prior to its merger with AT&T.[61] Although at the time it signed its Overlay contract with AT&T in 2005, TWTC was one of the few carriers that did not purchase UNEs,[62] it seems extremely unlikely that at least 11 carriers in AT&T's region would willingly give up their right to obtain transmission facilities at forward looking prices if AT&T did not continue to retain market power over the special access inputs needed by carriers to compete.

The AT&T Standard and Overlay discounts also have the effect of preventing CLECs from purchasing local transmission facilities from competitive wholesale providers. For example, Professor Pelcovtiz examined an SBC "MVP" contract, which has a similar structure to the TWTC/AT&T overlay contract.[63] Indeed, many of AT&T's

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[59] *See* SWBT Tariff F.C.C. No. 73 § 41.48.3 (E) (explaining that CLEC customers can only purchase two percent of their access services from SWBT as UNEs or they will lose the discount on special access services).

[60] *See* SWBT Tariff F.C.C. No. 73 § 38.3(C) (explaining that CLEC customers can only purchase five percent of their access services from SWBT as UNEs or their they will lose the discount on special access services).

[61] *SBC Communications Inc. and AT&T Corp. Applications for Approval of Transfer of Control*, Memorandum Opinion & Order, 20 FCC Rcd 18290, ¶ 43 (2005).

[62] After its recent merger with Xspedius TWTC now serves many of its customers with UNE loops.

[63] *See* Declaration of Michael Pelcovitz, attached to WorldCom Reply Comments, RM-10593 (filed Jan 23, 2003).

current contract tariffs are variants of the MVP plan. Like TWTC's overlay contract with AT&T, the MVP plan (1) resets the minimum annual revenue commitment, ("MARC") to a higher level based on prior spending even though the discount level is not related to the level of the MARC; (2) mandates that, if the customer misses the MARC, the customer must pay the difference between the amount purchased and the MARC or face substantial termination penalties and liabilities; (3) precludes the customer from purchasing more than a minimal number of UNEs; and (4) provides limited discounts (TWTC receives 5-12 percent discounts off of the Standard discount rate;[64] the MVP plan scrutinized by Prof. Pelcovitz provides 9-14 percent discounts) based not on the amount of spending, but rather the year of the plan.

Professor Pelcovitz concluded that the MVP plan (and therefore the TWTC Overlay contract) is an example of ILEC exclusionary pricing that prevents wholesale competition from developing. This is because, even though TWTC and other competitive wholesalers offer lower rates than AT&T offers under its cumulative discounts, CLEC purchasers are often precluded from moving any of their spending to the CLEC due to the risk of missing the MARC. According to Professor Pelcovitz, under the MVP plan, in order to overcome lost discounts and termination penalties, it would only be rational for a CLEC purchaser to shift 20 percent of its demand to competitive wholesalers only if the competitor could provide discounts from *45 to 70%* off of the ILEC's rates. *See id.* at 15. These discounts would have to be sustained by the competitive wholesaler over the life of the MVP contract. A competitive wholesaler would need to offer similar discounts to

[64] Pursuant to the AT&T/BellSouth merger conditions, TWTC chose to freeze the MARC and therefore froze its discount at 5 percent.

make it rational for customers subject to TWTC's overlay discount to purchase from the competitor.

B. ILEC Standard Discounts Have Similar Anticompetitive Effects

While the ILEC Overlay tariffs generally contain a MARC, the ILECs often note that any CLEC can qualify for the substantial discounts offered by the ILEC Standard discounts, regardless of their spending levels. In fact, these discounts are not available for packetized Ethernet services or OCn services. Where available, these tariffs have anticompetitive effects just like the Overlay offers. Like the Overlay contract tariffs, the Standard offers provide a discount off of the month-to-month rates to still extremely high levels while "locking-in" nearly all of a customer's demand with the ILEC.

The common denominator of all of the Standard discount offers is a circuit commitment based upon the customer's purchases at the time the agreement is signed. Over the term of the contract (which can be as long as 7 years in the case of Verizon), the purchaser must maintain purchases at or near the original commitment level. Some contracts, particularly AT&T's, reset the commitment level if a certain circuit maximum in passed. For example under the AT&T (Pac Bell) DS1 Term Pricing Plan, TWTC must maintain between 80 and 124 percent of its circuit commitment over the life of the contract. That is, if TWTC purchased 100 DS1 circuits at the time the contract was initiated, it must maintain a purchase level of between 80 and 124 DS1s for the life of the contract. If TWTC purchases fewer than 80 circuits in a particular year, it will face a shortfall penalty. If TWTC purchases more than 124 DS1s in a particular year (say 150 DS1s), the commitment will reset so that the following year, TWTC must purchase 80 percent of 150 DS1s (120 DS1s) or risk a shortfall penalty or contract termination the following year.

From the perspective of the ILEC, a commitment without a MARC or volume of circuit minimum seems odd -- TWTC will receive the *exact same percentage discount* from the ILEC regardless of whether it purchases 5 DS1s for the life of the contract or 5000. Such a discount scheme would at first blush seem inefficient from the ILEC's perspective because the discount is obviously not related to any ILEC economies of scale.

Yet this line of thinking misses the ILECs' objective. While ILECs might incur extra expense in providing discounts to low volume customers, it is plainly worth their while to do so because these contracts effectively lock-up CLEC demand. The purpose of AT&T's and other ILECs' similar Standard discounts is to prevent any special access purchaser, regardless of size, from ever shifting more than a minimal portion of their demand to a competitive wholesale provider even if the competitor's prices are lower.

For example, the Qwest RCP plan sets a 90 percent circuit commitment in exchange for a 22 percent discount off of month-to-month rates. If a carrier wanted to shift part of its demand to a competitive wholesaler, it would be in danger of missing its commitment. This danger is amplified if the CLEC purchaser's demand remains stagnant or decreases. For example, if a purchaser had a 100 DS1 circuit commitment under the RCP plan, it shifted only 5 circuits to a competitive wholesaler and lost 6 circuits because of customer disconnects, it would fall below its 90 percent commitment and face penalties and lost discounts. Standard discount offers like the Pac-Bell plan described above that reset the commitment at a higher level if the CLEC purchases "too many" circuits has the exact same "lock-up" effect.

At lower levels of demand, these commitments present substantial problems for CLEC purchasers. In that case, small circuit fluctuations can make the CLEC miss its

commitment levels. This is especially so if the contracts do not offer circuit portability, as some do not. Such a tight limit also severely limits the extent to which TWTC could utilize CLEC wholesalers. As discussed above, this is the reason that Xspedius, with its smaller special access footprint, did not opt into these plans and instead remained largely reliant on UNEs.

C. The AT&T/BellSouth Merger Conditions Have Not Prevented AT&T from Acting in a Discriminatory Fashion

The AT&T/BellSouth merger order banned certain particularly anticompetitive provisions in special access contracts, including explicit limits on UNE purchases.[65] However, because it retains market power over special access, AT&T simply extracts its monopoly rents in other ways. Without a holistic solution that provides a lower backstop price cap rate and that eliminates all unreasonable terms and conditions, ILECs will continue to be able to discriminate through higher prices or other means.

This theory is borne out in the behavior of AT&T following the imposition of conditions in the AT&T/BellSouth merger order. **[proprietary begin] [proprietary end]**

VII. THE COMMISSION SHOULD IMMEDIATELY ADOPT REGULATIONS THAT WILL DIMINISH THE ILECS' OPPORTUNITIES TO ABUSE THEIR MARKET POWER IN THE PROVISION OF SPECIAL ACCESS

It is clear from the foregoing that the ILECs have substantial and persisting market power over TDM (DS1 and DS3), OCn and packetized (e.g., Ethernet) local transmission services and that the ILECs have exploited this market power by increasing

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[65] *See AT&T Inc. and BellSouth Corp. Application for Transfer of Control*, Memorandum Opinion and Order, 22 FCC Rcd 5662, ¶ 8 (2007) ("The AT&T/BellSouth ILECs will not include in any pricing flexibility contract or tariff filed with the Commission after the Merger Closing Date access service ratio terms which limit the extent to which customers may obtain transmission services as UNEs, rather than special access services.").

prices (both in absolute terms and relative to what are likely declining average costs) and by engaging in exclusionary pricing practices. These pricing practices represent clear violations of the bedrock Communications Act requirement under Section 201(b) that ILECs offer special access services on just and reasonable terms and conditions. It could not be more obvious that the Commission's pricing flexibility rules are a failure. The Commission must therefore immediately adopt new regulations needed to ensure that the ILECs comply with the requirements of Section 201(b).[66] Where these changes require that ILECs file new tariffs, they should do so by January 1, 2008.

First, the Commission must ensure that ILECs lower their prices to levels that are just and reasonable. This requires that the Commission take several related steps. To

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[66] *See Petition of ACS of Anchorage, Inc. Pursuant to Section 10 of the Communications Act of 1934, as amended, for Forbearance from Section 251(c)(3) and 252(d)(1) in the Anchorage Study Area*, Memorandum Opinion and Order, 22 FCC Rcd 1958, n.159 (2007) ("To the extent our predictive judgment [that ACS has market incentives to offer reasonably priced non-UNE facilities] proves incorrect, carriers can file appropriate petitions with the Commission and the Commission has the option of reconsidering this forbearance ruling. *See Federal-State Joint Board on Universal Service, Petition of TracFone Wireless, Inc. for Forbearance from 47 U.S.C. § 214(e)(1)(A) and 47 C.F.R. § 54.201(i)*, CC Docket No. 96-45, Order, 20 FCC Rcd 15095, 15099, para. 6 n.25 (2005) (conditionally granting a forbearance petition and stating that if the Commission's 'predictive judgment proves incorrect and these conditions prove to be inadequate safeguards, then parties can file appropriate petitions with the Commission and the Commission has the option of reconsidering the forbearance ruling'); *see also Broadband 271 Forbearance Order*, 19 FCC Rcd at 21509, para. 26 n.85; *Petition of SBC Communications Inc. for Forbearance from Structural Separation Requirements of Section 272 of the Communications Act of 1934, as Amended, and Request for Relief to Provide International Directory Assistance Services*, CC Docket No. 97-172, Memorandum Opinion and Order, 19 FCC Rcd 5211, 5223-24, para. 19 n.66 (2004) (stating in a forbearance decision that to the extent carriers believe, in the future, that circumstances have changed and discriminatory practices have emerged with respect to these particular routes, they are free to file petitions); *CellNet Communications, Inc. v. FCC*, 149 F.3d 429, 442 (6th Cir. 1998) (upholding the Commission's predictive judgment stating that '[i]f the FCC's predictions about the level of competition do not materialize, then it will of course need to reconsider its sunsetting provision in accordance with its continuing obligation to practice reasoned decision-making.'").

begin with, it must eliminate Phase II pricing flexibility. Price cap ILECs (the only ILECs eligible for pricing flexibility) would then be required to include all TDM, OCn and packetized special access service offerings in all geographic areas in the special access price cap basket. This is necessary because, as the Commission has often stated, price cap regulation is the most appropriate means of regulating ILEC special access rates.

In addition, given the obvious flaws in the Commission's triggers for pricing flexibility (discussed above), there is no basis for continuing to allow ILECs to file for and receive Phase I pricing flexibility pursuant to the Phase I trigger. The Commission should promptly initiate a proceeding for the purpose of revisiting under what circumstances ILECs should be permitted to enter into volume and term contracts for special access. Until the resolution of such proceeding, it would be appropriate to allow ILECs to continue to exercise the Phase I pricing flexibility in areas in which they have in the past received such flexibility, subject to the prohibitions on exclusionary pricing practices discussed below.

The Commission should also make several fundamental adjustments to the special access price cap basket designed to bring ILEC prices for special access within a zone of reasonableness. As a preliminary matter, the Commission must address the fact that placing all special access services in the same price cap basket gives the ILECs too much freedom to increase the price of one type of service in the basket that is not subject to any competition while simultaneously reducing the price of a second service in the basket that is subject to some competition. The ILECs could use this tactic to charge prices for monopoly services that are far above cost (close to or at monopoly levels). This is a real

concern because, although the ILECs have been charging prices significantly above every available measure of cost for TDM, OCn and packetized special access services, the ILECs do face varying levels of competition for these services and competition for some subset of these services could develop further in the future. It is therefore appropriate to restrict the extent to which ILECs can dramatically increase prices for the categories of special access services for which the ILEC is likely to have the greatest market power. The Commission should do so by establishing separate service categories within the basket, each of which would be subject to a prohibition on any price increases in the first two years and each of which would be subject to an upward price increase limit of five percent per year in subsequent years. Such separate service categories should be established for the following: (1) DS1 channel terminations, (2) DS1 mileage, (3) DS3 channel terminations, (4) DS3 mileage and (5) Ethernet services (including Ethernet cross-connects).

The Commission must also re-initialize the price cap index ("PCI") for the special access basket at a level that yields overall lower rates than ILECs charge today. There are of course a variety of ways in which this could be accomplished, but the most appropriate means of addressing this issue is to utilize the 6.5 percent X-Factor for the special access price cap basket that the ILECs themselves agreed to as part of the CALLS proceeding. The Commission should do so by re-initializing the special access basket PCI as if all special access services (except for Ethernet services, discussed below) were subject to price caps from the beginning of CALLS until the present and as if the 6.5 percent X-Factor continued to apply after July 1, 2004 until today. That is, the PCI should reflect application of the 3 percent X-Factor from July 1, 2000 to June 30, 2001