

Edward H. Shakin
Vice President & Associate General Counsel
Federal Regulatory



1515 N. Courthouse Road
Suite 500
Arlington, VA 22201-2909
Phone 703-351-3099
Fax 703-351-3662
edward.h.shakin@verizon.com

VIA ECFS

August 15, 2007

Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street, SW
Washington, DC 20554

**REDACTED –
FOR PUBLIC INSPECTION**

*Re: Special Access Rates for Price Cap Local Exchange Carriers,
WC Docket No. 05-25 & RM-10593*

Dear Ms. Dortch:

Attached is the Redacted version of Verizon's Reply Comments and supporting materials in the above-captioned matters ("Reply"). Verizon is filing the Confidential version of this Reply under separate cover.

Thank you for your assistance in this matter. If you have any questions, please call me at 703-351-3099.

Very truly yours,

A handwritten signature in black ink, appearing to read "E. Shakin".

Edward H. Shakin

Attachment

cc: Margaret Dailey (via e-mail)
Best Copy and Printing (via e-mail)

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**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 & RM-10593

REPLY COMMENTS OF VERIZON

Michael E. Glover
Of Counsel

Edward Shakin
Sherry A. Ingram
VERIZON
1515 N. Courthouse Road
Suite 500
Arlington, VA 22201-2909
(703) 351-3065

Evan T. Leo
Scott H. Angstreich
KELLOGG, HUBER, HANSEN, TODD,
EVANS & FIGEL, PLLC
1615 M Street, N.W.
Suite 400
Washington, D.C. 20036
(202) 326-7930

August 15, 2007

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WC Docket No. 05-25 & RM-10593

REPLY COMMENTS OF VERIZON

INTRODUCTION AND SUMMARY

The only substantial evidence in the record shows that, since the implementation of pricing flexibility, special access rates have declined, competition has flourished, and customers have benefited through the introduction of new and innovative service plans.

In its opening comments, Verizon demonstrated that, over the past five years, prices paid by its special access customers have decreased by 27.7 percent per year in real terms (considering the effects of inflation). Even more impressive, these decreases occurred in the face of growing demand. And while the number of special access lines Verizon provided increased by between 16 and 26 percent per year, total special access revenues (excluding DSL and FiOS Data) remained relatively flat during that period. These facts show the polar opposite of market power – far from raising prices above competitive levels or restricting output, Verizon’s special access rates have continued to fall even as output has expanded.

Given the healthy state of special access competition, this is not surprising. Verizon submitted hundreds of pages of evidence confirming the existence of vigorous special access competition wherever there is appreciable demand for these services. Other price cap LECs submitted similarly extensive evidence, including competitive network maps, market share

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analyses, calculations of the percent of demand within easy reach of competitive fiber, and statistics regarding losses of special access business to cable companies and fixed wireless providers. The ability of competitors to serve customers throughout the areas where demand for high-capacity services is concentrated – along with the fact that ILEC special access rates are set over broad geographic areas – ensures that competition disciplines prices throughout those areas, and not merely with respect to the individual buildings or locations to which competitors have already deployed wireline or intermodal facilities.

In stark contrast to the ILECs' submissions, the proponents of more intrusive regulation have provided no maps of their networks, no lists of the buildings they serve or the central offices or carrier hotels where they have fiber-based collocation, no analyses of the percentage of special access demand within striking distance of their fiber, and no evidence of their success in serving business customers using special access purchased from incumbents or others. Although their strategy is perhaps understandable – after all, any customer of any service would prefer to pay lower prices than it already pays – it is unavailing, as the limited data available to ILECs, alone, demonstrates the existence of extensive intra- and intermodal competition today, and the strong potential for even greater competition tomorrow.

In addition, proponents of re-regulating special access have largely limited themselves to rehashing prior, previously refuted claims. A few of the larger wireless carriers, for example, repeat claims that special access rates are retarding wireless investment and competition. Such claims cannot be squared with the tens of billions of dollars wireless carriers (including those complaining here) are investing in their intensely competitive market, and the numerous

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intermodal competitors – including cable companies and fixed wireless providers – that are successfully competing to provide wireless backhaul services.

Other commenters cite statistics in the *GAO Report* on the percentage of buildings with facilities-based competitors, leading them to propose revisions in the pricing flexibility triggers.

As an initial matter, the *GAO Report* confirms that the prices customers actually pay have declined substantially, both in areas where carriers have pricing flexibility and in areas where they do not. The *GAO Report* further confirms that prices in both Phase I and Phase II areas

declined by *more than* would have been required by price caps alone. Moreover, the Commission correctly rejected a focus on individual buildings in the *Pricing Flexibility Order*, and it remains the case that MSAs best reflect the manner in which competition occurs.

Competing carriers do not target individual buildings in an area, but design and deploy their fiber rings and other facilities to pass near as many potential customers as possible in those areas where demand for high-capacity facilities is concentrated.

Price cap LECs, moreover, price special access across broad regions and not to individual buildings, so that the existence of competitive facilities (and potential for deployment of such facilities) at some locations within those broad regions effectively constrains prices throughout the region. In addition, the statistics in the *GAO Report* are not based on a complete record. The GAO did not have the benefit of the extensive competitive data that were before this Commission and the Department of Justice (“DOJ”) in the recent merger proceedings or the similarly extensive record here; had no data from the competitors themselves; and relied on a database known to understate significantly the extent of competition. Those statistics are also based on buildings with the lowest possible level of demand for high-capacity services. It would

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be inappropriate for the Commission to base its regulatory approach to special access to the availability of fiber connections to such buildings, which comprise a miniscule fraction of the total demand for special access services. In any event, customers in such buildings are actively pursued by cable companies and other intermodal competitors, and are successfully served by other carriers through a combination of ILEC special access and their own facilities.

Some commenters repeat familiar complaints about particular features of ILEC special access tariffs, claiming that such tariffs “lock up” potential competitors. Those claims are wrong, and the most widely voiced complaints do not apply to Verizon’s discount plans. These plans are *optional* and have generally been developed at the behest of potential customers to provide wholesale customers with significant flexibility – including the ability to move circuits in and out of the plans as they deploy their own facilities. And, as the D.C. Circuit recently recognized in overturning a Commission decision invalidating one particular plan, such discount plans are best understood as reflecting a bargain that purchasers are free to accept or reject. In all events, the record here shows that carriers are competing successfully using ILEC special access, as well as using their own self-supplied facilities and facilities obtained from third parties.

The proper course, therefore, is to provide incumbents with further flexibility to respond to their customers’ needs, and not to compel arbitrary and substantial rate reductions where the market is functioning effectively. In particular, the Commission should extend Phase I relief throughout the country so that carriers have the *option* of negotiating customized arrangements in *addition* to generally tariffed plans; eliminate restrictions on growth discounts, banded-mileage pricing, and other option pricing structures; and adopt additional competitive criteria for

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Phase II relief to take into account additional evidence of competitors' presence. Such actions will extend to greater numbers of consumers the benefits that ILECs' existing flexibility with respect to special access services has already created.

I. COMPETITION FOR SPECIAL ACCESS IS THRIVING

A. The Prices That Customers Pay for Special Access Services Have Been Steadily Decreasing, While Output Has Been Increasing

1. Price and Output Trends

Since the implementation of pricing flexibility in 2001, the prices that customers pay for special access services from Verizon have dropped by nearly 28 percent per year in real terms, while the prices that customers pay for DS1 and DS3 services each have declined by roughly 5 percent per year. *See* Verizon at 11-12; Taylor Supp. Decl. ¶¶ 11, 18 (attached to Verizon's comments as Attach. A). These declines occurred not only for Verizon's customers as a whole, but also for many of the most vocal proponents of re-regulation of special access. For example, the prices that **[Begin CLEC Confidential]** **[End CLEC Confidential]** paid Verizon for DS1 services fell a total of **[Begin CLEC Confidential]** **[End CLEC Confidential]** percent in real terms from 2002 through 2006; the rates it paid Verizon for DS3 services fell a total of **[Begin CLEC Confidential]** **[End CLEC Confidential]** percent in real terms during that same period. *See* Reply Declaration of Patrick A. Garzillo ("Garzillo Reply Decl.") Exh. 1 (Attach. C). Similarly, **[Begin CLEC Confidential]** **[End CLEC Confidential]** has seen the prices it paid Verizon for DS1 and DS3 services during that period fall, in real terms, by **[Begin CLEC Confidential]** **[End CLEC Confidential]** percent, respectively. *See id.* **[Begin CLEC Confidential]** **[End CLEC Confidential]** also has benefited from price declines and in 2006 was paying **[Begin**

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CLEC Confidential **[End CLEC Confidential]** percent less in real terms for the DS1 and DS3 services it purchased from Verizon than it was paying in 2002. *See id.*

These decreases occurred even though the Commission, at the time it instituted pricing flexibility, recognized that special access rates would not necessarily decline in all cases as a result of pricing flexibility because, among other factors, “our rules may have required incumbent LECs to price access services below cost.” *Pricing Flexibility Order*¹ ¶ 155. Nonetheless, these decreases occurred and, moreover, they did so in the face of substantial growth in the number of special access lines. *See Verizon* at 11-12; *Taylor Supp. Decl.* ¶¶ 9-11 & Table 1; *AT&T* at 22; *Qwest* at 46; *Embarq* at 9-10; *Iowa Telecom* at 10-11. This detailed evidence – which is the only evidence on the record regarding the rates customers actually pay for ILEC special access services – demonstrates that special access rates have decreased, not increased dramatically, under pricing flexibility.

A number of commenters here have also told the investment community – in stark contrast to their claims in the regulatory arena – that special access “is highly competitive and continues to experience downward pricing pressure.”² These companies “anticipate that aggressive price competition will continue”³ and that they “expect [to] continue to experience an overall price decrease for our services due to competition.”⁴ Indeed, these commenters tell investors that “ILECs have become more aggressive in pricing competition” and that, with

¹ *Access Change Reform; Price Cap Reform for Local Exchange Carriers*, Fifth Report and Order and Further Notice of Proposed Rulemaking, 14 FCC 14221 (1999) (“*Pricing Flexibility Order*”), *aff’d*, *WorldCom, Inc. v. FCC*, 238 F.3d 449 (D.C. Cir. 2001).

² *XO Holdings, Inc.*, Annual Report (Form 10-K), at 4 (Mar. 16, 2006).

³ *CBeyond Communications, Inc.*, Annual Report (Form 10-K), at 29 (Mar. 31, 2006).

⁴ *Covad Communications Corp.*, *2006 Annual Report* at 21.

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“several facilities-based carriers providing the same service in a given market, price competition is likely to continue.”⁵

Nonetheless, various commenters claim that, on one proposed metric or another, ILECs’ rates are too high. Those metrics are invalid, for reasons the Commission has previously recognized and that Verizon and others have detailed at length.

First, a number of commenters continue to focus on the rates of return for interstate special access services, calculated using ARMIS data. *See, e.g.*, Sprint Nextel at 8-10; XO *et al.* at 12-13; ATX *et al.* at 11-15; AdHoc at 5-6. At most, however, ARMIS may present a realistic picture of *overall* revenues, expenses, and investment – and, in that regard, Verizon’s *total* company return for regulated services in 2006 was 9.78 percent. *See* Verizon at 43. But ARMIS data cannot meaningfully be used to calculate rates of return for individual services or to assess trends in such returns. *See, e.g.*, Verizon at 43-45; Taylor Supp. Decl. ¶¶ 38-44; Supplemental Reply Declaration of William E. Taylor ¶¶ 42-49 (“Taylor Supp. Reply Decl.”) (Attach. A); AT&T at 34-36; Qwest at 50-53; Embarq at 10-11.⁶ The Commission, moreover, long ago recognized that such data “do[] not serve a ratemaking purpose.”⁷ Indeed, the Commission further emphasized that “reducing our regulatory reliance on earnings calculations based on accounting data is essential to the transition to a competitive marketplace.”⁸ Finally, in focusing

⁵ Time Warner Telecom Inc., Annual Report (Form 10-K), at 13 (Mar. 1, 2007).

⁶ *See also, e.g.*, Reply Comments of Verizon, *Special Access Rates for Price Cap Local Exchange*, WC Docket No. 05-25, at 8-12 (FCC filed July 29, 2005) (“Verizon Reply”); Reply Declaration of William E. Taylor ¶¶ 11-19 (“Taylor Reply Decl.”) (attached to Verizon Reply).

⁷ *Policy and Rules Concerning Rates for Dominant Carriers*, Order on Reconsideration, 6 FCC Rcd 2637, ¶ 194 (1991).

⁸ *Price Cap Performance Review for Local Exchange Carriers*, 12 FCC Rcd 16642, ¶ 150 (1997) (“1997 Price Cap Review Order”).

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on rates of return and costs – which cannot be measured in an economically meaningful way for an individual service, because of the inability to apportion common network costs in other than an arbitrary manner, among other things⁹ – these commenters are seeking a return to what the Commission properly abandoned years ago as an inferior regulatory mechanism, in decisions the D.C. Circuit upheld.¹⁰

Second, various commenters calculate tariffed rates for hypothetical stand-alone circuits, which they use to contend that ILECs' rates are too high, either by comparison to price cap rates or to rates in Phase I areas. *See, e.g.*, AdHoc at 12-13; XO *et al.* Attach. 2; Sprint Nextel Exh. 1. As an initial matter, many of these comparisons are based on month-to-month or base rates, “sticker prices” that virtually no purchaser actually pays. Although comparisons involving such rates are meaningless from a competitive perspective, Verizon has not filed for rate increases on its “sticker prices” for DS1 and DS3 circuits in Phase II areas where Verizon has received pricing flexibility and, therefore, those rates have remained the same since July 2002 when Verizon first implemented pricing flexibility. *See* Taylor Supp. Reply Decl. ¶ 8. Even when these commenters purport to make comparisons to discounted rates, their calculations still fail because customers do not purchase pure DS1 or DS3 circuits, but instead normally combine them to complete their networks, where, for example, traffic from multiple DS-1 channel

⁹ *See* Verizon at 42; Taylor Supp. Decl. ¶¶ 30-33; AT&T at 38; Embarq at 12-13.

¹⁰ *See Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, 5 FCC Rcd 6786 (1990) (“*LEC Price Cap Order*”); *see also Price Cap Performance Review for Local Exchange Carriers*, First Report and Order, 10 FCC Rcd 8961, ¶ 64 (1995) (“*1995 Price Cap Review Order*”) (recognizing that a price cap system “was not only superior to rate-of-return regulation, but could also act as a transitional system as LEC regulated services became subject to greater competition”).

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terminations will be combined onto a DS-3 or higher capacity SONET ring for transport. *See* Taylor Supp. Decl. ¶ 17.

The commenters' comparisons to price cap rates, moreover, ignore the Commission's acknowledgement that, once pricing flexibility was implemented, rates would not necessarily decline in all cases, but would instead move both up and down, pushing toward some equilibrium price, consistent with what occurs in a competitive market. *See Pricing Flexibility Order* ¶ 155. In fact, however, prices customers pay in both Phase I and Phase II areas have declined by *more* than would have been required by the GDP-PI adjustment alone.¹¹ The commenters' focus on the supposed price differential between Phase I and Phase II areas, while likewise besides the point, ignores that, in Phase II areas, customers are shifting demand toward discount plans and contract tariffs, resulting in a reduction in the rates customers actually pay, even if the month-to-month rates or base rates have stayed the same or even increased. *See* Taylor Supp. Reply Decl. ¶¶ 20-24.

Third, some commenters compare DS1 rates to those for DSL or Verizon's FiOS service. *See, e.g.,* Sprint Nextel at 23-24; ATX *et al.* at 15-16. But these commenters are comparing apples to oranges. Sprint Nextel, for example, compares the price of *residential, entry-level* DSL and FiOS service to the DS1 service that is sold to other carriers and businesses. *See* Sprint Nextel at 23-24. Although ATX *et al.* quotes the price of a FiOS business product, it too picks the entry-level product. Verizon DSL and FiOS products that offer symmetrical upstream and downstream data capability – just as DS1 service does – have prices that are comparable to DS1

¹¹ *See* GAO, Report to the Chairman, Committee on Government Reform, House of Representatives, *FCC Needs To Improve Its Ability To Monitor and Determine the Extent of Competition in Dedicated Access Services*, GAO-07-80, at 32 (Nov. 2006) (“GAO Report”).

prices.¹² In addition, these commenters ignore that a DS1 provides a guaranteed level of service, while DSL and FiOS generally provide best efforts Internet access. Businesses and carriers that value that guarantee and require it for their business applications understandably are willing to pay more for that benefit.

Fourth, some commenters draw an apples to oranges comparison between long-haul transport rates and rates for special access services. *See* Global Crossing at 3-4; Time Warner Telecom/One Comm. at 39. But the economic and technological characteristics of long-haul transport are very different from those of shorter-haul special access transport. *See* Taylor Reply Decl. ¶¶ 34-43. First, the fixed costs of providing service are spread over a much greater number of miles in long-haul transport than in short-haul transport. Accordingly, the amount of fixed costs that must be recovered per mile will be much smaller in the long-haul context. Second, the variable costs of long-haul transport are much lower, as long-haul transport is likely to be routed along railroad rights-of-way or other above-ground routes, and often will traverse long stretches of relatively uncongested, lesser populated or substantially lower rural areas where construction costs are substantially lower. Short-haul transport, in contrast, is provided principally in metropolitan areas, where streets must be dug up in order to place cables under ground and construction costs are much higher.

¹² For example, with a one-year agreement, a business can obtain a symmetrical 5 Mbps FiOS service, with a static IP address, for \$224.99 per month. *See* Verizon, Packages & Prices, <http://www22.verizon.com/content/businessfios/packagesandprices/packagesandprices.htm> (last visited Aug. 13, 2007). Similarly, Verizon's "Premium DSL" service, with symmetrical 1.5 Mbps speed and a static IP address, is \$222.00 per month, with a one-year agreement. *See* Verizon, Generally Available Terms and Conditions, http://www22.verizon.com/dslmembersonly/docs/GATC-TermsandConditionVer1_2.pdf (last visited Aug. 13, 2007).

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Fifth, numerous commenters note that special access rates are higher than rates for comparable unbundled network elements, which are priced using the TELRIC methodology. *See, e.g.*, Sprint Nextel at 21-23; XO *et al.* at 16-20; ATX *et al.* at 36-38. All such a comparison shows is that TELRIC has been used to set rates *below* levels that prevail in competitive markets. *See* Taylor Reply Decl. ¶ 27. In the real world, prices in a competitive market are not equal to the hypothetical cost that would be faced by a firm serving the entire market as a wholesale provider that regularly replaces its existing plant with the most efficient available technology (as TELRIC presumes). *See id.*; Verizon Reply at 14-17. Finally, as discussed in detail below, the Commission could not require incumbents to sell their special access services at TELRIC-based rates: such a rule would ignore the clear differences the Supreme Court recognized between the pricing standards in § 201 and § 252(d)(1),¹³ as well the D.C. Circuit’s rulings that the Commission may not require the provision of TELRIC-priced UNEs without first making a finding of impairment, based on substantial evidence, and taking into account the costs of mandating unbundling.¹⁴

2. Discount Plans

In response to competition and to meet customer demand, Verizon has introduced special access discount pricing plans (with price breaks of 40 percent or more off month-to-month rates)

¹³ *See Verizon Communications Inc. v. FCC*, 535 U.S. 467, 489, 510, 515, 516 (2002) (noting that § 252(d)(1) applies only to “bottleneck elements” and is “*radically unlike* all previous [just and reasonable rate] statutes,” including § 201, and “appears to be an *explicit disavowal* of the familiar . . . rate regulation” under those other statutes, “in favor of [a] *novel ratesetting*” methodology) (emphases added).

¹⁴ *See USTA v. FCC*, 290 F.3d 415, 425 (D.C. Cir. 2002) (“*USTA I*”) (holding that Congress “made ‘impairment’ the touchstone” for UNE requirements); *USTA v. FCC*, 359 F.3d 554, 572, 576, 582 (D.C. Cir. 2004) (“*USTA II*”).

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and individually negotiated contract tariffs (with additional discounts up to 30 percent). *See* Lew Supp. Decl. ¶ 5 (attached to Verizon’s comments as Attach. B). Yet, even with these discounts, Verizon regularly loses substantial business to wholesale customers that self-supply or obtain alternative facilities from traditional special access competitors, cable companies, utilities, or fixed wireless competitors. *See* Verizon at 7-10; Declaration of Quintin Lew ¶¶ 71-72 (“Lew Decl.”), attached to Comments of Verizon, *Special Access Rates for Price Cap Local Exchange*, WC Docket No. 05-25 (FCC filed June 13, 2005).

In addition, Verizon’s wholesale customers are successfully using special access services obtained from Verizon to compete against Verizon in providing a wide range of services to the full range of business customers. *See* Lew Decl. ¶¶ 45-52; Lew Supp. Decl. ¶¶ 34-39. These providers have experienced tremendous growth, with **[Begin CLEC Confidential]**

[End CLEC Confidential], for example, increasing their number of DS1s in service by more than **[Begin CLEC Confidential]** **[End CLEC Confidential]**, respectively, over the past four to five years. *See* Lew Supp. Decl. ¶¶ 36-37. This experience confirms the reasonableness of Verizon’s special access rates, terms, and conditions.

Proponents of further special access regulation concede that they receive substantial discounts off month-to-month rates special access rates, *see, e.g., XO et al.* at 28-29, but contend that they receive these discounts only if they commit to lease all or a majority of their high-capacity facilities from the ILEC to the exclusion of alternative providers or self-provisioning, or agree to what they claim are unreasonable volume commitments. *See XO et al.* at 27; PAETEC at 12-13; Global Crossing at 8-9; Comptel at 11. Similarly, they argue that termination fees are

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unreasonable and prevent them from moving to alternative providers. *See XO et al.* at 28-29.

None of this is true.

a) Carriers Can Obtain Substantial Discounts on Verizon’s Special Access Services Without Making Any Minimum Service Commitment at All

Verizon offers a variety of plans that provide discounts on Verizon’s special access services; plans that contain minimum service commitments, such as Verizon’s Commitment Discount Plans, are just one type of these plans. *See* Lew Decl. ¶¶ 64-67; Lew Supp. Decl. ¶¶ 5-12. Other, “circuit-specific” discount plans – which provide discounts on particular circuits during the term of the plans – provide the same level of discounts on Verizon’s special access services as Verizon’s Commitment Discount Plan, but require no minimum service commitment at all. *See* Lew Decl. ¶ 65; Lew Supp. Decl. ¶ 6.

A customer that purchases a circuit under a “circuit-specific” plan for a five-year term will receive the *same discount* as a customer that subscribes to Verizon’s Commitment Discount Plan for a five-year term. *See* Supplemental Reply Declaration of Quintin Lew ¶ 19 (“Lew Supp. Reply Decl.”) (Attach. B). The discounts under Verizon’s Service Discount Plan and Term Pricing Plan apply, moreover, even if a customer orders only a small number of circuits – in some instances as few as 1 to 20 DS1s – under those plans. *See id.* Accordingly, a customer does not need to commit large volumes of its special access business with Verizon to receive large discounts. Even a customer with small special access volumes can receive significant discounts on Verizon’s special access services without making minimum service commitments. *See id.* Indeed, some of Verizon’s carrier customers with smaller special access volumes, such as **[Begin CLEC Confidential]** **[End CLEC Confidential]**

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purchase under these plans and receive substantial discounts without making any minimum service commitment at all. *See id.*

b) Verizon Plans with Minimum Service Commitments Do Not Preclude Carriers from Pursuing Alternatives but Instead Facilitate that Option

Contrary to commenters' claims, Verizon's discount plans with minimum service commitments do not "lock up" their special access business by requiring them to purchase *all* of their special access services with Verizon. The volume commitments in Verizon's plans apply only to the special access services the carrier purchases with Verizon at the time the customer signs up for the plan, and there is no requirement that any percentage of the customer's *overall* special access purchases be from Verizon. *See id.* Verizon's plans do not require carriers to terminate service with other providers and move that business to Verizon. Nor do Verizon's plans preclude the carrier from self-provisioning. *See id.* In fact, Verizon rarely knows to what extent carriers are self-provisioning or purchasing from other providers. *See* Lew Supp. Decl. ¶ 23. Any growth in a carrier customer's special access type services, therefore, may be given to alternative suppliers or placed on the carrier's own network. *See id.* Alternatively, if the Commission was to eliminate its restrictions on growth discounts – and it should – these carriers could choose to reap the rewards of their own growth with larger savings. *See* Verizon at 46-47.

Contrary to commenters' claims in this proceeding, these plans are popular: many of these commenters have moved from Verizon's circuit-specific plans to the Commitment Discount Plans because of the flexibility and ease of administration such plans provide. *See* Lew Supp. Reply Decl. ¶ 11. In exchange for the minimum service commitment, and after a one-year service period, Verizon allows carriers to move circuits in and out of the Commitment Discount Plans and to get the full discount on circuits while they are in the plan with no termination

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liability. As a result, these plans give carriers room to enter into agreements with their individual retail customers for terms shorter than the one the carrier has selected under the Commitment Discount Plans.¹⁵

Carriers can and do use the flexibility these plans offer to move circuits off of Verizon's network and on to its own network as they build out their facilities or even to move them to alternative providers. For example, **[Begin CLEC Confidential]** **[End CLEC Confidential]** recently converted approximately 200 special access circuits obtained under Verizon's Commitment Discount Plan to UNEs with Verizon. *See* Lew Supp. Reply Decl. ¶ 13.¹⁶ Similarly, **[Begin CLEC Confidential]** **[End CLEC Confidential]** which had purchased services under Verizon's Term Volume Plan, a plan in the Verizon West serving area which contains a minimum service commitment, recently informed Verizon that it was moving **[Begin CLEC Confidential]** **[End CLEC Confidential]** circuits from Verizon to FiberTower. *Id.* Because these plans cover broad regions, a carrier

¹⁵ Although *XO et al.* (at 29) suggest that Verizon obtains an advantage because it need not require its own retail customers to commit to two year terms, Verizon Business, which manages Verizon's retail sales, leases facilities from the ILEC under the same terms and conditions as Verizon's carrier customers and, therefore, faces the same issues when managing retail customer commitments.

¹⁶ Despite examples like this, some commenters complain about discount plans that offer increased discounts for customers that commit not to purchase UNEs (or not to exceed a set percentage of their circuits obtained from the ILEC as UNEs). *See, e.g., ATX et al.* at 51-52. Verizon recently offered a pricing flexibility promotion that provided additional discounts on converted special access circuits to those carriers that choose to convert UNEs to special access. The plan was entirely optional and was designed to help those carriers that seek to transition from UNEs to special access; as Verizon has shown, substantial discounts are available to other carriers irrespective of whether they also obtain UNEs from Verizon. In any event, because UNE rates typically are set below any realistic measure of cost, all such a promotion was intended to do was to ensure that, in exchange for the benefit to the customer of significant discounts on its converted special access purchases, the carrier providing those services would have a greater opportunity to recover the costs of serving the customer.

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could start by obtaining 100 circuits from Verizon in New Jersey, build out their facilities there or obtain those circuits instead from a third-party provider, and add circuits from Verizon in Maryland, where it is just starting to do business – all while still receiving the benefits of discounts under the plan. *See id.*

These types of plans, in fact, have been so popular that Verizon recently responded to its carrier customer's requests for a similar plan that will provide this type of circuit portability across the Verizon footprint. *See* Lew Supp. Decl. ¶ 7. The National Discount Plan, which Verizon introduced earlier this year, does just that and has a two-tiered structure: one tier provides substantial discounts for customers that commit to maintain 85 of their in-service circuits with Verizon, and the second tier provides even greater discounts for customers that choose a 90 percent volume commitment. *See id.* ¶¶ 9-11. In addition, in response to carrier requests, the discounts under the National Discount Plan are based both on the term commitment and on the customer's volume. *See id.* ¶ 9. Contrary to XO *et al.*'s claims here (at 27), customers with very little volume can participate in the plan and obtain substantial discounts. The first volume tier for DS1s and DS3s, which is 0 to 30,000 DS1 equivalents, provides discounts of greater than 30 percent off month-to-month special access rates for those services. *See* Lew Supp. Reply Decl. ¶ 16.¹⁷

¹⁷ Global Crossing (at 8) complains about a supposed need to “pay the mileage component to reach the customer premises” from its own collocation site at the customer's serving wire center. Verizon, at least, does not charge a mileage component for the link between the serving wire center and the customer's premises. To the extent that Global Crossing, instead, is referring to interoffice transport mileage, it is free to self-provision that transport or to obtain it from one of the many third parties that have deployed fiber networks in the areas where special access demand is concentrated. *See* Verizon Attach. H. In all events, Verizon's National Discount Plan includes a banded mileage pricing structure, under which circuits of varying lengths within a band will have the same mileage cost. *See* Lew Supp. Decl. ¶ 10. Verizon

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Furthermore, contrary to *XO et al.*'s claims (at 29-30), if a carrier is unable to meet its 90 percent commitment for a given review period, that carrier is *not* required to pay the full amount that would have been due through the contract term. *See* Lew Supp. Reply Decl. ¶ 15. Instead, the shortfall payment structure in Verizon's Commitment Discount Plans favors the customer and the fees are entirely reasonable. The review period or "true-up" process occurs only every six months and is determined based on the average number of circuits in service over the six month period. As a result, even if a carrier falls below the minimum service commitment during any particular month within that six-month period, there is no shortfall assessment as long as, on average, the carrier met its minimum volume level. *See id.*

Moreover, the shortfall assessments are reasonable. Carriers are not required to refund credits they received on all services. Instead the "shortfall" is the difference between what the carrier paid, on average, for the number of circuits it maintained and what it would have paid had that carrier met its commitment. *See id.* So, for example, if a carrier commits to maintain 90 out of 100 of its circuits in service, but the six-month review reveals that it maintained only 85, the shortfall assessment is only the average circuit price for the 5 circuits for which that carrier was short for that period. *See id.* Contrary to *XO et al.*'s claims (at 33), reasonable shortfall fees and circuit portability facilitate carriers' ability to move circuits leased from Verizon to alternative providers or to their own facilities.

implemented this plan voluntarily, in response to customer demand, showing that Global Crossing's proposal (at 8) that the Commission mandate such pricing structures is unnecessary. In addition, as Verizon explained, the Commission's current rules contain restrictions on ILECs' introduction of such flat-rated- or banded-mileage pricing structures; as Verizon explained, the Commission should eliminate those restrictions. *See* Verizon at 50.

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c) Termination Provisions in Verizon’s Tariffs Are Fair and Reasonable and Do Not Prevent Customers from Moving Off Verizon’s Network

Although some commenters complain about termination liability in Verizon’s discount plans, *see, e.g., XO et al.* at 28-29, imposing termination liability when a customer discontinues service under a term plan prior to its expiration is a legitimate means of ensuring that a service provider recovers the costs incurred in initiating and continuing to provide service to customers that receive discounts in exchange for term commitments.¹⁸ Termination liabilities enable carriers to recover facility costs and up-front sunk costs involved in provisioning circuits to special access customers. Similarly, when a customer agrees to a term commitment in exchange for a greater discount, termination liability assures that the service provider gets the benefit of the bargain if the customer terminates prior to expiration of the agreement. *See BellSouth Telecomms., Inc. v. FCC*, 469 F.3d 1052, 1060 (D.C. Cir. 2006) (holding that discount plans and contract tariffs are “most naturally viewed as a bargain containing terms that both benefit and burden its subscribers”). Termination liability, therefore, makes it possible for Verizon to offer substantial discounts to its customers. Without termination liabilities, carriers would have to seek more onerous obligations, such as substantial up-front payments, or discontinue term discounts altogether. *See Lew Supp. Reply Decl.* ¶ 20.

¹⁸ *See, e.g., Expanded Interconnection With Local Telephone Company Facilities*, Second Memorandum Opinion and Order on Reconsideration, 8 FCC Rcd 7341, ¶ 40 (1993); *Application by Bell Atlantic New York for Authorization Under Section 271 of the Communications Act to Provide In-Region, InterLATA Service in the State of New York*, Memorandum Opinion and Order, 15 FCC Rcd 3953, ¶¶ 375, 390 (1999), *aff’d*, *AT&T Corp. v. FCC*, 220 F.3d 607 (D.C. Cir. 2000); *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, ¶ 648 (2003) (“*Triennial Review Order*” or “*TRO*”) (“[W]e have come to recognize more clearly the difficulties and limitations inherent in competition based on the shared use of infrastructure through network unbundling), *vacated in part and remanded*, *USTA v. FCC*, 359 F.3d 554 (D.C. Cir. 2004).

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Contrary to some commenters' claims, the termination provisions in Verizon's tariffs are fair and reasonable and do not prevent carrier customers from moving services off of Verizon's network on to their own or an alternative providers' facilities. If a circuit-specific plan is terminated prior to expiration of the term commitment, the customer generally is no worse off than the customer would have been had the customer signed up for the term equivalent to the time the circuit actually was in service with Verizon. *See id.* ¶ 21. For DS1s and DS3s in Verizon's East serving area, for example, the customer pays the lesser of (1) a specific percentage (15 or 50 percent, depending on the plan) of the monthly rate for the unexpired portion of the term; or (2) the difference between the rates for the term the customer subscribed to and the rates for the term the customer could have satisfied. In addition, because Verizon's discount plans come in a variety of terms, ranging from 1 to 10 years, carriers that wish to move their special access circuits to another provider or to their own facilities in the short term can opt for shorter-term plans and still receive significant discounts off Verizon's month-to-month rates. *See id.*

For Verizon's non-circuit specific plans, such as the Commitment Discount Plan, termination liability applies *only* if the plan is terminated in its entirety. *See id.* ¶ 22. That is, customers are free to terminate individual circuits as long as they maintain the minimum service commitment described above. If a customer does terminate a non-circuit specific plan in its entirety, the customer generally will receive the discounts to which it is entitled; termination liability is calculated in the same manner as described for Verizon's circuit specific plans. *See id.*

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B. The Record Demonstrates That There Is Extensive Facilities-Based Competition for High-Capacity Services

1. Facilities-Based Competition Comes from Fiber-Based Competitors, Cable Companies, and Fixed Wireless Providers, Among Others

Verizon has provided comprehensive, verifiable evidence from a wide range of sources showing intense facilities-based competition for and competitive self-supply of high-capacity services, including third-party data from GeoTel and GeoResults regarding fiber networks deployed and buildings lit by alternative providers and detailed, publicly available information regarding more than two dozen carriers' local high-capacity networks. *See* Verizon at 13-29 & Attachs. E-I; Lew Supp. Decl. ¶¶ 22-33; *see also* Supplemental Declaration of Parley C. Casto (AT&T) ¶¶ 10-21 ("Casto Supp. Decl.") & Attach. Verizon also demonstrated that cable and fixed wireless providers are competing aggressively for high-capacity customers, including smaller businesses and wireless carriers. *See* Verizon at 21-24; *see also* AT&T at 15-16, 18-21; Qwest at 29-39; Embarq at 5-8. Verizon and other commenters also provided specific examples of intra- and intermodal providers winning significant contracts to provide high-capacity services and wielding credible threats of moving their business to alternative sources of supply. *See* Verizon at 30-37; Lew Supp. Decl. ¶¶ 34-39; Casto Supp. Decl. ¶¶ 46-50; Declaration of Thomas Cogan (Qwest) ¶¶ 2-4; Embarq at 6-8. Even smaller price cap carriers report "increasing demand for special access services" and competition from not only the traditional large IXC's, "but also from local sources," including "cable providers[] [and] consortia." ITTA at 2.

In contrast to Verizon's detailed showing, most competitive providers have chosen either not to provide detailed information about their networks and operations, or not to participate here at all. Not one of these parties that has filed comments submitted network maps, lists of

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buildings served, or any other probative evidence, all of which is within their control. And any number of aggressive special access competitors – including traditional telecommunications providers such as Level 3 and AboveNet, cable companies such as Comcast, Cox, Time Warner Cable, and Cablevision, and fixed wireless providers such as Towerstream, FiberTower, and Tower Cloud – declined to file comments at all, thereby depriving the Commission of data in their possession. At the same time, these companies continue to announce their successes to the marketplace. Just this week, XO and SAVVIS announced a multi-year, multi-million dollar agreement under which XO will provide SAVVIS with local access network services.¹⁹

The silence of those that did file comments on their network and operations requires the Commission to infer that this evidence would undermine their arguments, and precludes the Commission from granting the relief they request. Indeed, the Commission must infer that data that competitors obviously maintain but have purposely withheld are unfavorable to them. *See International Union v. NLRB*, 459 F.2d 1329, 1336 (D.C. Cir. 1972) (“[W]hen a party has relevant evidence within his control which he fails to produce, that failure gives rise to an inference that the evidence is unfavorable to him.”). One commenter expressly agrees with this principle, proposing that a party’s “refus[al] to provide any relevant evidence in its possession” should lead to “an adverse inference” about what that evidence would show. PAETEC Exh. A at 4. Nonetheless, PAETEC – no different from the other proponents of re-regulating special access – has withheld from the Commission all the relevant evidence in its possession.

¹⁹ XO Communications, Press Release, *Multi-Year Agreements SAVVIS Next Generation Buildout and Delivery of IT Infrastructure Services* (Aug. 13, 2007), available at <http://www.xo.com/news/357.html>.

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In any case, even the limited data that competitors have provided confirm that there is extensive facilities-based competition wherever appreciable demand for high-capacity services exist. Global Crossing claims to operate “the world’s first integrated global IP-based network. Its core network connects more than 300 cities and 30 countries worldwide, and delivers services to more than 500 major cities, 50 countries and 5 continents around the globe.” Global Crossing at 2. McLeodUSA “has invested over \$ 3 billion in network facilities including switches, transport facilities, long-haul fiber, and in rare instances, OCn loops to customer premises. McLeodUSA has either built these facilities or acquired them from other carriers.” ATX *et al.*, Declaration of Don Eben ¶ 3. ITC^Deltacom “has invested hundreds of millions of dollars in network facilities including switches, data network, inter-city transport facilities, and OCn transport to ILEC central offices and to other service providers. Deltacom has either built its facilities or acquired them from other carriers.” ATX *et al.*, Declaration of Steven H. Brownworth ¶ 3. Time Warner Telecom “has invested over \$2.5 billion in its network and has deployed nearly 21,000 route miles of fiber, of which over 13,000 route miles have been deployed in local metro networks.” Time Warner Telecom/One Comm App. A ¶ 4. “XO owns and operates fiber optic rings with associated switching and fiber optic equipment that serve 75 metro area markets in 26 states.” XO *et al.*, Declaration of Ajay Govil (XO) ¶ 2.

2. *Claims That Insufficient Facilities-Based Competition Warrants Increased Regulation, Including Changes to the Pricing Flexibility Triggers, Cannot Be Sustained on this Record*

Despite the evidence detailed above, various commenters claim that facilities-based competition is insufficient and that pricing flexibility should be curtailed – or eliminated – including by revising the pricing flexibility triggers to focus on the existence of competitive

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facilities at individual locations. Others argue for increased regulation of special access circuits used for wireless backhaul, notwithstanding the intense competition existing today to serve that market segment. The Commission should reject these claims and, instead, should grant ILECs more, not less, flexibility to meet the needs of their customers.

First, a number of carriers cite the *GAO Report* in support of their claims that facilities-based competition is lacking and that re-regulation of special access is warranted. *See, e.g.*, Global Crossing at 3; PAETEC at 10; NJDRC at 17; Time Warner Telecom/One Comm. at 6; ATX *et al.* at 30-35; BT Americas at 12-14. The *GAO Report*, in fact, properly and repeatedly acknowledges that special access rates have *declined* in both Phase I and Phase II areas since the advent of pricing flexibility. *See GAO Report* at 14, 27-28, 32. The *GAO Report* further confirms that customers in areas with complete pricing flexibility (*i.e.*, Phase II areas) are paying significantly *less* for high-capacity services than they were prior to the advent of pricing flexibility, and that prices in both Phase I and Phase II areas declined by *more than* would have been required by the GDP-PI adjustment alone. *See id.* at 32. And the GAO emphasized that it “does not call for the reregulation of dedicated access prices.” *Id.* at 15, 44.

Nonetheless, these commenters point to the statement in the *GAO Report* that facilities-based competitors serve fewer than 6 percent of buildings with at least DS1-level demand in the specific MSAs that GAO examined. *See id.* at 12, 19. Yet, as Verizon and others have previously demonstrated, GAO’s analysis in this regard was flawed in numerous respects. *See Verizon* at 37-39; *see also AT&T* at 51-57; *Qwest* at 48-50. Indeed, the *GAO Report*’s 6 percent figure results from an understated numerator (the number of buildings served) and an overstated denominator (the number of buildings with appreciable demand).

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With respect to the numerator, although GAO asked competitors to identify the buildings to which they have deployed facilities, *no competitor provided such data* – just as none has done so here. Although GAO recognized (at 40) that such competitors have an incentive to provide biased or incomplete data, the *GAO Report* then inconsistently uses the absence of such data to claim that there is only limited facilities-based competition.²⁰ In addition, GAO did not review data (much of it confidential) that the Commission and DOJ collected and analyzed in evaluating the extent to which there is facilities-based competition for high-capacity services in areas served by Verizon and AT&T.²¹ That information, however, is in the record here, as is additional evidence from since the time of the Commission’s merger reviews.

Compounding the problem caused by the lack of competitor-provided data and the failure to consider data collected and reviewed by the Commission and DOJ, GAO utilized the Telcordia Location Registry database as its *sole source* of data relating to deployment to individual buildings. *See GAO Report* at 9-10 & App. I. GAO expressly noted, however, that this database understates the extent of competition. *See id.* at 19 n.30. As GAO acknowledges, many CLECs do not provide Telcordia with information about their network deployment. *See id.* at 21, 51. And CLECs that do provide information to Telcordia submit only selective (and incomplete) data, because they are well aware those data may be used in regulatory proceedings.

²⁰ In addition, although the *GAO Report* acknowledges (at 8) that the availability of TELRIC-priced UNEs can undermine incentives to invest in competitive facilities, it ignores the effects of this disincentive, incorrectly implying that the limitations on the availability of DS1 and DS3 UNEs adopted in the *Triennial Review Remand Order* (“*TRRO*”) substantially cut back on the availability of those UNEs. *See, e.g., GAO Report* at 42. In reality, the *TRRO* rules limit the availability of DS1 and DS3 UNEs in only a very small minority of wire centers nationwide.

²¹ Verizon offered to provide GAO with access to the information submitted to the Commission and DOJ, but GAO did not take Verizon up on that offer.

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Likewise, contrary to the report's apparent assumptions (*see* Table 2 and note b), few cable companies provide complete and accurate data to Telcordia, even though these companies are moving aggressively to serve smaller businesses. *See, e.g., Verizon* at 21-23, 31-32.²²

A further flaw was GAO's limitation of its analysis to facilities already deployed to individual buildings. Once competitors have deployed fiber *networks* in an area, they can cost-effectively extend those networks to serve customers in individual *buildings* where there is sufficient demand. The prospect of such competition provides an additional check on special access rates. Yet, GAO appears not to have considered any data relating to the extent to which other carriers had deployed fiber networks in the 16 MSAs it studied.

Turning to the denominator, the *GAO Report* focuses on buildings with as little as one DS1 of demand, even though the vast majority of special access connections – both from incumbents and competitors – go to buildings with much more than one DS1 of demand. Not surprisingly, and particularly in light of the above limitations in the data GAO reviewed, the *GAO Report* finds that alternative providers largely have not deployed facilities to such buildings. In fact, evidence shows that, as telecommunications expenditures increase, facilities deployment to the building also increases. Thus, even as long as two years ago, competitive facilities already had been deployed to roughly 50 percent of the buildings with demand of \$2 million or greater, and such facilities already extended to nearly 70 percent of the buildings with

²² This likely explains why competition – according to the *GAO Report* (at 20) – appears so much greater in Norfolk, a location where the *GAO Report* indicates (at 21 & Table 2, note b) some cable-company information was available, than in other MSAs examined by GAO, where it appears such data were not available. In reality, competition from cable companies in providing high-capacity services is extensive, robust, and constantly increasing wherever special access demand is concentrated – not just in Norfolk, as the *GAO Report* counter-intuitively assumes.

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more than \$6 million in demand.²³ And the *GAO Report* further acknowledges (at 12, 19, 26) that CLECs frequently deploy facilities to buildings where there is demand for at least two DS3s (the equivalent of 48 DSIs). Indeed, even the limited data GAO reviewed on competitive deployment reveal that CLECs already have extended competitive facilities to at least 25 percent of buildings with two DS3s or greater demand. *See id.* at 19 & Table 2. GAO's model, therefore, overestimates the number of buildings in which there is likely to be significant special access demand and fails to acknowledge that, given the marketplace reality of concentrated demand, competitors' facilities reach the majority of special access demand and can easily be extended to reach the remainder.

Second, many commenters presume that, unless a particular building already has a second (or third) fiber connection, competition cannot constrain the prices offered at that building. This presumption leads some to propose revising the existing pricing flexibility triggers to focus instead on deployment to individual buildings. These proposals, however, are based on the same erroneous reasoning many of these same commenters presented in arguing for nationwide unbundling. When the Commission previously accepted those commenters' views and applied a building-by-building approach in the UNE context, the D.C. Circuit vacated the Commission's unbundling rules for failing to take account of the manner in which competition to serve large business customers occurs.²⁴ The Commission, along with DOJ, also rejected such claims based on a comprehensive record in the Verizon/MCI and SBC/AT&T merger

²³ *See* Exhibit 6 to Declaration of Judy K. Verses, attached to Comments of Verizon, *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, WC Docket No. 04-313 (FCC filed Oct. 4, 2004).

²⁴ *See USTA II*, 359 F.3d at 575.

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proceedings.²⁵ Indeed, the Commission specifically found that competitors' attempts to conduct price studies showing the supposed effect on prices at particular locations based on the presence or absence of competitive fiber were flawed.²⁶

The Commission, moreover, considered and properly rejected such claims in the *Pricing Flexibility Order*, when it established the Phase I and II triggers to provide for pricing flexibility on an MSA-wide basis. The Commission found that MSA-wide relief was appropriate, where those triggers are met, because an MSA “best reflect[s] the scope of competitive entry, and therefore [is] a logical basis for measuring the extent of competition.” *Pricing Flexibility Order* ¶ 72. The Commission also found that the “increased expenses and administrative burdens” that would be required if pricing flexibility were granted on a wire center basis far outweighed any conceivable benefits from such an approach. *Id.* ¶ 74.

It remains the case that, when wireline competitors enter a market using their own facilities, they do so by designing and deploying fiber rings that span (and can serve customers in) those areas where demand for high-capacity services is concentrated.²⁷ Those carriers can then serve not only the specific buildings they have designed those rings to reach, but also

²⁵ See *Verizon Communications Inc. and MCI Inc., Applications for Transfer of Control*, Memorandum Opinion and Order, 20 FCC Rcd 18433, ¶¶ 36-55, 65-81 (2005) (“*Verizon/MCI Order*”); Press Release, DOJ, *Justice Department Requires Divestitures in Verizon’s Acquisition of MCI and SBC’s Acquisition of AT&T* (Oct. 27, 2005), available at http://www.usdoj.gov/opa/pr/2005/October/05_at_571.html.

²⁶ See *Verizon/MCI Order* ¶ 46 (“[W]e do not accept the commenters’ bid data analyses as demonstrating that the merger will lead to special access price increases at particular buildings.”).

²⁷ See, e.g., *Unbundled Access to Network Elements; Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, Order on Remand, 20 FCC Rcd 2533, ¶ 154 (2005) (“*Triennial Review Remand Order*” or “*TRRO*”), *aff’d*, *Covad Communications Co. v. FCC*, 450 F.3d 528 (D.C. Cir. 2006).

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buildings near those rings. Whether a competitor can economically deploy a lateral to reach a particular building, therefore, depends primarily on how it designed its fiber ring. In addition, it is necessary to consider *all* the revenues that a carrier expects to earn over a facility, not merely the revenues for the special access services alone, but also for the various voice and data services that a carrier may be able to provide. The analysis must also recognize that a carrier will often be able to serve multiple customers at a given location. Significantly, the total enterprise revenue opportunities available to competing providers are expanding. Analysts project, for example, that total business services revenues will increase from \$106 billion in 2007 to \$118 billion in 2010.²⁸

In setting the triggers themselves, the Commission focused on the extent to which an MSA contained “the presence of facilities-based competition with significant sunk investment,” which the Commission measured using collocation as a proxy, despite recognizing that “collocation may *underestimate* the extent of competitive facilities within a wire center, because it fails to account for the presence of competitors that do not use collocation and have wholly bypassed incumbent LEC facilities.” *Pricing Flexibility Order* ¶¶ 80, 95. The Commission rejected proposals to “determine what proportion of the incumbent’s customers the competitor can serve with those facilities.” *Id.* ¶ 94. The Commission recognized the extreme difficulty of such analysis in light of the “lack of verifiable data concerning competitors’ . . . facilities,” noting that competitors “often are unwilling to provide this information voluntarily” – a condition that persists to this day. *Id.* ¶¶ 95-96. The Commission further noted that such a rule would “distort the operation of the market” by enabling competitors to “prevent an incumbent

²⁸ See Thomas O. Seitz, Lehman Brothers Equity Research, *Telecom Services – Wireline* at 4, Fig. 5 (Oct. 18, 2006).

from obtaining pricing flexibility in an MSA simply by choosing not to enter certain parts of that MSA or to serve certain customers.” *Id.* ¶ 143. And the Commission’s prediction that new entrants “will eventually extend [their] own facilities to reach [their] customers,” *id.* ¶ 104, is borne out by the record here.

Verizon submitted evidence of the costs Verizon Business has incurred in the past 18 months in building such laterals, and Verizon Business’s experience is that a lateral of up to one-quarter mile in length – that is, up to 1,320 feet long – in a major urban area can, in most cases, be constructed for less than \$100,000. *See* Brown/Tarazi Decl. ¶ 13 (attached to Verizon’s comments as Attach. C). Thus, if the cost of constructing a proposed lateral were \$72,000, access revenues totaling only approximately \$3,000 per month from all the customers in that building would pay for that circuit within two years; on a five- or seven-year payback, revenues of only \$1,200 or about \$860 per month from all the customers in that building would be required. Competing carriers have provided the Commission with some data regarding their costs of deploying fiber in prior Commission proceedings, and these data are generally consistent with Verizon’s documented experience. For example, Advanced TelCom stated in 2004 that, “to reach a building located a 1/2 mile from an existing Advanced TelCom LSO Access Ring would typically cost approximately \$100,000 to \$150,000,” while a lateral of “just 300 feet [would cost] approximately \$25,000 - \$30,000.”²⁹ Cavalier offered a similar estimate – \$30,000 to \$50,000 to extend a short lateral from its ring to an individual location.³⁰ Other CLEC estimates

²⁹ Declaration of Dan J. Wigger (Advanced TelCom) ¶ 21, attached to Initial Comments of the Loop Transport CLEC Coalition, *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, WC Docket No. 04-313 (FCC filed Oct. 4, 2004).

³⁰ Declaration of Brad A. Evans (Cavalier Telephone, LLC) ¶ 20, attached to Comments of the Association for Local Telecommunications Services, *Review of the Section 251*

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were consistent with these figures, typically ranging from \$20 to \$40 per foot (which translates to roughly \$110,000 to \$210,000 per mile), and in extreme cases (*e.g.*, very dense urban streets) as high as \$100 per foot.³¹

The Commission's triggers thus "balance both the desires for precision and simplicity and the costs to carriers and customers alike of delaying the grant of pricing flexibility." *Pricing Flexibility Order* ¶ 96. The Commission's determinations were upheld in all respects by the D.C. Circuit, which found that the Commission had made "reasonable policy determination[s]" and had "thoroughly explained" its decision "to grant incumbent LECs relief from existing regulations upon certain competitive showings." *WorldCom*, 238 F.3d at 452, 460. As the record here shows, the Commission should not retreat from these determinations, but should further them, by taking steps to ensure that all sunk investments in competitive facilities – not merely those that result in collocation in ILEC wire centers – are counted toward the Phase II triggers. *See Verizon* at 48-50.

Unbundling Obligations of Incumbent Local Exchange Carriers, CC Docket No. 01-338 (FCC filed Oct. 4, 2004).

³¹ Declaration of James C. Falvey (Xspedius) ¶ 21, attached to Initial Comments of the Loop Transport CLEC Coalition, *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, WC Docket No. 04-313 (FCC filed Oct. 4, 2004). (estimates the costs of deploying a lateral at "anywhere from \$21 to \$40 per foot (which translates to \$110,880 to \$211,200 per mile)"); Joint Declaration of Eleuterio (Teo) Galvan Jr. and Francisco Maella ¶ 90, attached to Comments of Alpheus Communications, L.P., *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, CC Docket No. 01-338 (FCC filed Oct. 4, 2004) (in downtown Dallas, "the lateral that a CLEC needs to deploy may be from 500 feet to 5,000 feet at a cost of over \$100 per foot, and up to \$400 per foot if it is a moratorium street."); Declaration of Mark A. Jenn (TDS Metrocom, LLC) ¶ 14, attached to Comments of ATX, *et al.*, *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, CC Docket No. 01-338 (FCC filed Oct. 4, 2004) (TDS CLECs have found that it can cost up to \$20-\$30 per foot and up to \$150,000 per mile to lay fiber).

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For all these reasons, analysis of the ability of market forces to constrain prices cannot be limited to the particular buildings to which alternative carriers have deployed fiber to date. Such a static, backward-looking measure ignores the potential for future deployment of competitive wireline facilities – as well as the extensive deployment and potential for continued deployment of intermodal facilities, including from cable companies and fixed wireless providers – all of which also constrains prices. *See id.* at 21-25. Moreover, it ignores the fact that ILECs do not offer special access prices on a building-by-building basis, offering higher or lower rates depending on whether competitive facilities are deployed to that building.³² Instead, ILECs’ special access rates are set across broad regions that are roughly as large in size as an MSA. *See* 47 C.F.R. § 69.3(e)(7). Therefore, the presence of actual competitive facilities in an MSA – both fiber rings and laterals – disciplines prices throughout that area, and the Commission should not insist on facilities being deployed to any number of particular buildings before granting Phase I or Phase II pricing flexibility.

Third, Sprint Nextel and T-Mobile repeat prior claims that the rates for ILEC special access used for backhaul from cell tower sites are inhibiting investment in wireless broadband and harming retail competition. *See* Sprint Nextel at 33-36; T-Mobile at 8. Sprint Nextel’s former ILEC affiliate – Embarq – rightly derides these claims as “hollow.” Embarq at 20. Wireless services are intensely competitive, and there is no evidence that special access is impeding wireless competition or investment. *See* Taylor Supp. Decl. ¶¶ 49-50. The wireless industry is marked by decreasing prices, expanding output, and massive investment in new technologies – including approximately \$25 billion since 2005 alone. *See* Verizon at 34-35;

³² *See Verizon/MCI Order* ¶ 48 & n.131.

AT&T at 46-48; Qwest at 42-44. The Commission just last week reaffirmed that the wireless market “is effectively competitive, and that competitive pressures continue to result in the introduction of innovative pricing plans and service offerings.”³³ Sprint Nextel and T-Mobile have affirmed this to the Commission, stating that wireless is “fiercely competitive,” “vigorous and dynamic,”³⁴ and that “carriers have been spurred by competition to invest billions of dollars . . . and to implement successive waves of technological improvements.”³⁵

Verizon and other commenters also submitted extensive evidence that the expected five-fold increase in the demand for bandwidth at individual cell sites over the next few years has led to a rapidly growing number of competitive suppliers – including fiber-based carriers, fixed wireless companies, and cable operators – vying to serve the niche for wireless backhaul. *See* Verizon at 25-28; AT&T at 14-15; Qwest at 39-41. Wireless carriers are also using microwave technology to self-provision their wireless backhaul links. *See* Verizon at 28-29. In addition, the Commission has a pending rulemaking proceeding – initiated in response to a petition from FiberTower, a leading fixed wireless provider – that would permit the use of smaller, lower-cost

³³ *Service Rules for the 698-746, 747-762 and 777-792 MHz Bands*, Second Report and Order, WT Docket No. 06-150, FCC 07-132, ¶ 200 (rel. Aug. 10, 2007)

³⁴ Comments of Sprint Nextel Corporation at 3, *Broadband Industry Practices*, WC Docket No. 07-52 (FCC filed June 15, 2007); Application for Transfer of Control at 64, *Applications of Nextel Communications, Inc., Sprint Corporation, for Consent to the Transfer of Control of Entities Holding Commission Licenses and Authorizations Pursuant to Sections 214 and 310(d) of the Communications Act*, WT Docket No. 05-63 (FCC filed Feb. 8, 2005); *see also* Comments of T-Mobile USA, Inc. at 18, *Skype Communications S.A.R.L. Petition to Confirm a Consumer’s Right to Use Internet Communications Software and Attach Devices to Wireless Networks*, RM-11361 (FCC filed Apr. 30, 2007) (“The U.S. wireless services marketplace is extraordinarily competitive.”).

³⁵ Reply Comments of T-Mobile USA, Inc. at 15, *Skype Communications S.A.R.L. Petition to Confirm a Consumer’s Right to Use Internet Communications Software and Attach Devices to Wireless Networks*, RM-11361 (FCC filed May 15, 2007).

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antennas in the 11 GHz band, enabling “new competition over a broad range of services, including . . . T-1 transport,” including “at sites that are otherwise incapable of supporting large antennas.”³⁶ The record shows that these intra- and intermodal alternatives to ILEC special access have had significant competitive successes, the most recent of which is FiberTower’s August 1, 2007 announcement of an agreement with Sprint Nextel to provide backhaul services in seven of Sprint’s initial markets where it is building its WiMax network.³⁷ See Verizon at 26-27; AT&T at 17; Embarq at 7.

Against this extensive evidence of robust intermodal competition, Sprint Nextel points only to the percentage of DS1 and DS3 circuits it is purchasing from ILECs *today*. See Sprint Nextel at 30; *see also* T-Mobile at 6. This backward-looking statistic says nothing about the extent to which alternative providers – both intra- and intermodal – and self-provision exert competitive pressures on *future* sales of wireless backhaul services. Nor does it indicate that Sprint Nextel have no choices when obtaining backhaul facilities. Indeed, Sprint acknowledges having a database of at least 77 alternative providers of special access and equivalent services. See Sprint Nextel at 31. In similarly dynamic and growing market segments, the Commission has rightly refused to base regulatory decisions on static snapshots.³⁸ The Commission should

³⁶ *Amendment of Part 101 of the Commission’s Rules to Modify Antenna Requirements for the 10.7 – 11.7 GHz Band*, Notice of Proposed Rulemaking, 22 FCC Rcd 6057, ¶ 7 (2007).

³⁷ See Press Release, FiberTower, *Fiber Tower Announces Backhaul Agreement with Sprint Nextel for WiMax Buildout* (Aug. 1, 2007).

³⁸ See also *Appropriate Framework for Broadband Access to the Internet over Wireline Facilities*, Report and Order and Notice of Proposed Rulemaking, 20 FCC Rcd 14853, ¶ 50 (2005) (“*Wireline Broadband Order*”) (rejecting “arguments . . . premised on data that are both limited and static” because they “fail to recognize the dynamic nature of the marketplace forces,” including growth of and investment in “existing and developing platforms”), *petitions for review pending*, *Time Warner Telecom Inc. v. FCC*, Nos. 05-4769 *et al.* (3d Cir. argued Mar. 16, 2007);

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take the same approach here and should reject Sprint Nextel's and T-Mobile's calls for re-regulation of special access services used for wireless backhaul. Such re-regulation would serve only to discourage investment in and deployment of alternative facilities, as those facilities-based providers would have to compete with facilities sold at regulated, below-market rates.³⁹

Fourth, a few commenters briefly take issue with the ability of cable companies to offer intermodal alternatives to ILEC special access. *See XO et al.* at 25; BT Americas at 9; Time Warner Telecom/One Comm. at 15-16. Although cable companies chose not to participate in this proceeding – depriving the Commission of the best source of evidence on their networks, investment, and success in competing for business customers – the record clearly shows that cable companies are investing substantially in their fiber networks and are also successfully offering their cable modem services to business customers. *See Verizon* at 21-23; *AT&T* at 18-19; *Qwest* at 39. This is true not only in major metropolitan areas,⁴⁰ but also in areas served by

Petition on Behalf of the State of Hawaii, Public Utility Commission, for Authority To Extend Its Rate Regulation of Commercial Mobile Radio Services in the State of Hawaii, Report and Order, 10 FCC Rcd 7872, ¶ 26 (1995) (“evidence concerning dynamic factors” such as “[g]rowth and investment” is a “more persuasive market indicator than evidence concerning static factors” such as “prices or rates of return”); *MTS-WATS Market Structure Inquiry*, Second Report and Order, 92 F.C.C.2d 787, ¶ 133 (1982) (“Regulatory policy must take cognizance of the dynamic factors existing in the marketplace. It should not be based solely on static conditions existing today.”).

³⁹ *See, e.g., TRO* ¶ 288; *Petition for Forbearance of the Verizon Telephone Companies Pursuant to 47 U.S.C. § 160(c)*, Memorandum Opinion and Order, 19 FCC Rcd 21496, ¶ 24 (2004) (“*271 Broadband Forbearance Order*”), *petition for review denied, EarthLink, Inc. v. FCC*, 462 F.3d 1 (D.C. Cir 2006).

⁴⁰ *See* Scott Moritz, *Cablevision's Got Fiber*, TheStreet.com (Sept. 20, 2006), <http://www.thestreet.com/newsanalysis/techtelecom/10310196.html> (reporting Cablevision's claim to have “more fiber” than “any phone company” in the New York-New Jersey-Connecticut tri-state area).

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smaller price cap ILECs, which are also seeking competition from cable providers. *See* ITTA at 2.

In addition, cable companies' networks are fully capable of offering speeds comparable to or greater than DS1 facilities (1.5 Mbps), which is the type of special access purchased by the lower end of the enterprise market. For example, Time Warner Cable's "Road Runner Business Class" provides speeds up to 2 Mbps upstream and 8 Mbps downstream.⁴¹ Comcast Workplace offers download speeds of up to 8 Mbps and uploads of up to 1 Mbps.⁴² Comcast boasts that its Workplace was "ranked number one in small business broadband customer satisfaction."⁴³ Cablevision also offers "Optimum Online for Business," which it describes as a "super-fast, reliable and affordable broadband service that's ideal for just about any business."⁴⁴ Cable companies are also investing billions of dollars in their fiber networks, which they are using to serve business customers. *See, e.g.,* Verizon at 21-22.

C. The Record Demonstrates That There Is Extensive Competition for All Retail Services That Are Provided with High-Capacity Facilities Including Special Access

As Verizon and others have demonstrated, there is intense competition in the provision of downstream services that use high-capacity facilities. *See* Verizon at 29-37. To the extent

⁴¹ *See* Time Warner Cable, *Time Warner Cable Business Class*, http://www.twcny.com/index2.bus.cfm?c=new_bus/roadrunner (last visited Aug. 14, 2007).

⁴² *See* Comcast, *Comcast Workplace: Key Features*, http://www.comcast.com/corporate/shop/business/cw_high_speed_internet.html (last visited Aug. 13, 2007).

⁴³ Comcast, *Comcast Workplace: Put Comcast Workplace To Work for You*, http://www.comcast.com/corporate/shop/business/comcast_workplace.html (last visited Aug. 13, 2007).

⁴⁴ Cablevision, *Optimum Online for Business: Features*, <http://www.optimum.com/business/ool/features.jsp> (last visited Aug. 13, 2007).

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commenters attempt to dispute this, they do so by repeating arguments they raised in the Verizon-MCI merger proceeding (and the SBC-AT&T and AT&T-BellSouth proceedings), and that the Commission rejected. *See, e.g.*, AdHoc at 15-21; ATX *et al.* at 17-23; PAETEC at 3-7; XO *et al.* at 35-41. In its orders approving those mergers, the Commission found that retail competition for enterprise customers is “strong” and will remain so “because medium and large enterprise customers are sophisticated, high-volume purchasers of communications services that demand high-capacity communications services, and because there [are] a significant number of carriers competing in the market.”⁴⁵ The Commission recognized that “interexchange carriers, competitive LECs, cable companies, other incumbent LECs, systems integrators, and equipment vendors” all “are prepared to make competitive offers” to enterprise customers and therefore “ensure that there is sufficient competition.”⁴⁶ Commenters’ belated calls for reconsideration of the decisions the Commission reached in approving those transactions provide no basis for the Commission to second-guess those decisions. The record here shows that, as the Commission concluded, the mergers would not harm – and, on the contrary, would increase – competition in the provision of high-capacity services to enterprise and other business customers.

⁴⁵ *Verizon/MCI Order* ¶ 56; *see also SBC Communications Inc. and AT&T Corp., Applications for Approval of Transfer of Control*, Memorandum Opinion and Order, 20 FCC Rcd 18290, ¶ 56 (2005) (“*SBC/AT&T Order*”).

⁴⁶ *Verizon/MCI Order* ¶¶ 64, 74; *see also SBC/AT&T Order* ¶¶ 64, 73; *AT&T Inc. and BellSouth Corporation, Application for Transfer of Control*, Memorandum Opinion and Order, 22 FCC Rcd 5662, ¶¶ 70, 80 (2007) (“*AT&T/BellSouth Order*”).

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II. THERE IS NO MERIT TO CLAIMS THAT THE COMMISSION SHOULD RE-REGULATE SPECIAL ACCESS SERVICES

A. Proponents of Re-Regulation of Special Access Bear a Heavy Legal Burden, Which They Cannot Meet on this Record

As this Commission has recognized in numerous contexts, economic regulation – particularly rate regulation – is warranted only in clear cases of market failure and, even then, only when the benefits of government intervention outweigh the costs.⁴⁷ In other circumstances, price-setting is a job best left to competitive forces, which consistently prove themselves better than regulators at maximizing consumer welfare. In industries that are undergoing rapid technological change – as is now occurring with the provision of special access – it is particularly difficult for even the most capable regulator to keep up with the market’s evolution.⁴⁸ Under these settled regulatory principles, there is no basis for renewed price regulation of special access services.

First, high-capacity services including special access exhibit no signs of market failure or a “monopoly market structure” that would be required to justify imposition of *ex ante* rate regulation.⁴⁹ On the contrary, over the past two decades, the Commission has found increased

⁴⁷ See, e.g., *Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor*, First Report and Order, 85 F.C.C. 2d 1, ¶ 4 (1980) (“*Competitive Carrier First Report and Order*”) (subsequent history omitted); *Pricing Flexibility Order* ¶ 144 & n.375; see also Declaration of Howard Shelanski ¶ 2, *Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements*, WC Docket No. 02-112 (FCC filed Mar. 29, 2007) (“Shelanski Decl.”); see Free State Foundation App. A at 5.

⁴⁸ See Stephen Breyer, *Regulation and Its Reform* 286-87 (1982); Alfred E. Kahn, *The Economics of Regulation* 127 (1971); John C. Panzar & Robert D. Willig, *Free Entry and the Sustainability of Natural Monopoly*, 8 Bell J. Econ. 1, 21 (1977); Richard A. Posner, *Natural Monopoly and Its Regulation*, 21 Stan. L. Rev. 548, 636 (1969).

⁴⁹ Shelanski Decl. ¶ 2.

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competition in the market for special access services.⁵⁰ These findings are more true today than ever. As explained in detail in Verizon’s comments (at 13-37), extensive competition exists both at the wholesale and retail levels. Customers enjoy a wide array of discount plans and intense competition in each category of retail services that uses special access (including the highly competitive wireless sector). The wholesale sector features facilities-based competition, including extensive competitive fiber and intermodal competition from cable and fixed wireless. These conditions are far from the monopoly market structure that might justify *ex ante* rate regulation.

Were it to decide otherwise, moreover, the Commission would bear the heavy burden of establishing that its prior conclusions about special access were wrong and that market failure now exists where none did previously.⁵¹ As the Second Circuit has explained, “when an agency reverses its course, a court must satisfy itself that the agency knows it is changing course, has

⁵⁰ See, e.g., *Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers*, Order, 5 FCC Rcd 7507, ¶ 210 (1990) (“New facilities-based competition has emerged in the high capacity special access market.”); *Expanded Interconnection with Local Telephone Company Facilities*, Second Notice of Proposed Rulemaking, 7 FCC Rcd 7740, ¶ 7 (1992) (granting ILECs “increased pricing flexibility to respond to competition for special access services”); *1995 Price Cap Review Order* ¶ 25 (noting “growing evidence that an increasing variety of local telecommunication services is available on a competitive basis,” which was “most pronounced in larger urban areas where new entrants appear to be marketing their transport and other local services to high-volume toll users that offer the most lucrative returns.”); *Pricing Flexibility Order* ¶ 14 (stating that the Commission has taken steps to increase pricing flexibility to allow LECs to “respond to the advent of competition in the exchange access market,” including special access); *id.* ¶ 19 (“we have observed competition develop in the marketplace”).

⁵¹ See, e.g., *Motor Vehicle Mfrs. Ass’n v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29, 41-42 (1983) (where an agency embarks on “a reversal of the agency’s former views as to the proper course,” it “is obligated to supply a reasoned analysis for the change”); *Fox Television Stations, Inc. v. FCC*, 280 F.3d 1027, 1044-45 (D.C. Cir. 2002) (finding it arbitrary and capricious for FCC not to “address its [earlier] findings in the course of its contrary [subsequent]” report).

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given sound reasons for the change, and has shown that the rule is consistent with the law that gives the agency its authority to act.”⁵² In addition, ““*the agency must explain why the original reasons for adopting the rule or policy are no longer dispositive.*”⁵³

Given that special access competition is far more extensive today than it was at the time of the *Pricing Flexibility Order*, which the D.C. Circuit upheld in full, it is hard to see how the Commission could meet these heavy burdens. And there is no way the Commission could reverse course and withstand judicial scrutiny based on anything less than a comprehensive record that includes data from *all* relevant parties – a record that does not exist here because of the conscious decisions of competitors to withhold data or not to participate in this proceeding. Unlike in prior proceedings where the Commission cited the insufficiency of data as a basis for not taking deregulatory steps,⁵⁴ in this proceeding it is the Commission and other parties seeking to re-regulate that seek to change the status quo and that bear the burden of proof that such changes are warranted.

Second, the Commission would also bear the burden of proving that, even if certain locations were unable to attract competitive special access facilities in the past, future competitive entry also is unlikely. The competitive analysis must be appropriately forward-

⁵² *Fox Television Stations, Inc. v. FCC*, 489 F.3d 444, 456 (2d Cir. 2007) (quoting *New York Council, Ass’n of Civilian Technicians v. Federal Labor Relations Auth.*, 757 F.2d 502, 508 (2d Cir. 1985)).

⁵³ *Id.*

⁵⁴ *See, e.g., Petition of Qwest Corporation for Forbearance Pursuant to 47 U.S.C. § 160(c) in the Omaha Metropolitan Statistical Area*, Memorandum Opinion and Order, 20 FCC Rcd 19415, ¶ 50 (2005) (“*Qwest Omaha Forbearance Order*”) (declining to grant forbearance from dominant carrier regulation with regard to enterprise services “due to a lack of . . . information”), *petitions for review denied in part, dismissed in part, Qwest Corp. v. FCC*, 482 F.3d 471 (D.C. Cir. 2007).

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looking and must take into account all types of competing special access providers, as well as reasonable substitutes for traditional special access, that are already present or are now emerging regardless of technology. The Commission previously has held that, where, as here, new technologies and new providers are emerging, competition “is more appropriately analyzed in view of larger trends in the marketplace, rather than exclusively through the snapshot data that may quickly and predictably be rendered obsolete as th[e] market continues to evolve.”⁵⁵ The Commission accordingly will “consider technological and market changes, and the nature, complexity, and speed of change of, as well as trends within, the communications industry.”⁵⁶ The Commission will examine both “actual and potential competition” that “either is present, or readily could be present.”⁵⁷

Applying this framework, the Commission would be required to consider competition, and the availability of self-supply, from all intermodal technologies, not just competition from traditional fiber, and to rule these out as potential sources of competition. As a general matter, and as shown in Verizon’s and others’ comments, the telecommunications industry is experiencing rampant competition, both within traditionally defined sectors such as local telephone service and across categories in what the Commission has recognized as skyrocketing intermodal competition. *See* Verizon at 13-37; Lew Supp. Decl. ¶¶ 22-29; AT&T at 8-21; Qwest

⁵⁵ *Wireline Broadband Order* ¶ 50.

⁵⁶ *Applications of AT&T Wireless Services, Inc. and Cingular Wireless Corporation for Consent To Transfer Control of Licenses and Authorizations*, Memorandum Opinion and Order, 19 FCC Rcd 21522, ¶ 41 (2004).

⁵⁷ *Qwest Omaha Forbearance Order* ¶ 62.

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at 19-41.⁵⁸ As to special access in particular, there is extensive competitive fiber deployment wherever there is appreciable special access demand, and additional fiber deployment is possible and likely in all areas where comparable levels of demand materialize. *See Verizon* at 14-20. In addition, Verizon faces growing intermodal competition from cable and fixed wireless. *See id.* at 20-25. And wireless carriers and others use alternative technologies to self-supply and meet their own high-capacity needs. *See id.* at 28-29. For this inquiry, too, the Commission would need to collect data from the range of intermodal competitors, which often shun regulatory proceedings.

Third, the Commission would further be required to demonstrate that the benefits of re-imposing price regulation outweigh the substantial costs. *See, e.g., Pricing Flexibility Order* ¶ 144 & n.375 (“Almost 20 years ago, the Commission determined that regulation imposes costs on common carriers and the public, and that a regulation should be eliminated when its costs outweigh its benefits.”). Such a finding would directly contradict the findings in the *Pricing Flexibility Order* to the effect that, “[a]s the [special access] market becomes more competitive, [regulatory] constraints become counter-productive.” *Id.* ¶ 19. Indeed, at that time, the Commission found “no public benefit in *any further delay* in regulatory relief” for incumbents that satisfied the Commission’s competitive triggers. *Id.* ¶ 92 (emphasis added). The Commission would have to establish a sound basis for coming to the diametrically opposed conclusion today.

⁵⁸ *See, e.g., Qwest Omaha Forbearance Order* ¶ 59 (finding that “substantial intermodal competition for telecommunications services” justified lifting certain regulations governing local service in Omaha).

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In any event, a conclusion that the benefits of regulation outweigh the costs is even less supportable today than it was when the Commission released the *Pricing Flexibility Order*. Special access, like other telecommunications services, is far *more* competitive today than they were at that time. Moreover, the industry now has much more experience with deregulation in many of its sectors, and the track record of such deregulation provides further evidence that market forces are superior. As Verizon has demonstrated here and elsewhere, deregulation of wireless and broadband services has been central to the enormous competition and investment that have occurred in those sectors.⁵⁹ By contrast, experience with regulating markets with even nascent competition have proved disastrous – as was the case with the cable industry in 1992 and local telecommunications services in 1996. Congress’s attempt to re-regulate cable rates in 1992, despite emerging competition from DBS, did not result in lower prices and had the effect of suppressing investment.⁶⁰ Likewise, attempts to stimulate local competition and investment through the UNE platform also had the opposite effect, as the Commission itself recognized years later,⁶¹ and since that time significant competition has emerged.

⁵⁹ See, e.g., Comments of Verizon and Verizon Wireless on the Notice of Inquiry at 20-26, *Broadband Industry Practices*, WC Docket No. 07-52 (FCC filed June 15, 2007); Comments of Verizon and Verizon Wireless on the Fifth Notice of Inquiry at 3-12, *Inquiry Concerning the Deployment of Advanced Telecommunications Capability to All Americans in a Reasonable and Timely Fashion, and Possible Steps To Accelerate Such Deployment Pursuant to Section 706 of the Communications Act*, GN Docket No. 07-45 (FCC filed May 16, 2007).

⁶⁰ Thomas W. Hazlett, *Cable Television Rate Deregulation*, 3 Int’l J. Econ. Bus. 145, 147 (1996) (“quality-adjusted prices had not been lowered by rate controls”; that is, the prices went up with deregulation, but not when adjusted for the quality of the product consumers received).

⁶¹ See *TRRO* ¶¶ 199, 210 (“[T]he continued availability of unbundled mass market switching would impose significant costs in the form of decreased investment incentives.”); *id.* ¶ 218 (“It is now clear . . . that, in many areas, UNE-P has been a disincentive to competitive LECs’ infrastructure investment.”); *TRO* ¶ 3.

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Fourth, the Commission would be required to demonstrate how any attempt to re-impose rate regulation is consistent with the deregulatory mandate of the 1996 Act. In enacting the 1996 Act, Congress made explicit its goal of “promot[ing] competition and reduc[ing] regulation in order to secure lower prices and higher quality services for American telecommunications consumers and encourage the rapid deployment of new telecommunications technologies.” Pub. L. No. 104-104, pmb., 110 Stat. 56, 56 (1996). The Act’s “deregulatory and competitive purposes” are not a matter of controversy.⁶² In the past, courts have indicated that agencies will be held to a high standard when they attempt to circumvent a deregulatory congressional policy. The D.C. Circuit, in reviewing the Interstate Commerce Commission’s (“ICC”) exercise of its statutory exemption authority under the Staggers Act⁶³ – authority similar to the Commission’s forbearance authority under 47 U.S.C. § 160⁶⁴ – rejected the ICC’s attempt to “adopt[] something akin to a new regulation,” in light of the fact that “Congress envisioned” the Staggers

⁶² *Verizon Communications*, 535 U.S. at 502 n.20; *accord National Cable & Telecomms. Ass’n v. Brand X Internet Servs.*, 545 U.S. 967, 1001 (2005) (upholding the Commission’s conclusion that the purpose of the 1996 Act is to foster “a minimal regulatory environment that promotes investment and innovation in a competitive market”) (internal quotation marks and citation omitted); *Cellco P’ship v. FCC*, 357 F.3d 88, 96-103 (D.C. Cir. 2004) (emphasizing the 1996 Act’s “deregulatory purpose”).

⁶³ Staggers Rail Act of 1980, Pub. L. No. 96-448, 94 Stat. 1895 (1980) (“Staggers Act”). The Staggers Act, not unlike the 1996 Act, was enacted “to dismantle the regulatory scheme established by the Interstate Commerce Act” as to the railroads, as to which Congress had decided that “greater reliance on the marketplace” was warranted. *G&T Terminal Packaging Co. v. Consolidated Rail Corp.*, 830 F.2d 1230, 1236-37 (3d Cir. 1987) (Aldisert, J., dissenting) (quoting H.R. Conf. Rep. No. 96-1430, *as reprinted in* 1980 U.S.C.C.A.N. 4110, 4111)).

⁶⁴ The relevant provision of the Staggers Act – similar to Section 10 of the 1996 Act, 47 U.S.C. § 160 – required the ICC “to exempt” regulated parties from statutory obligations when it found that “(1) is not necessary to carry out the transportation policy . . . ; and (2) either (A) the transaction or service is of limited scope, or (B) the application of a provision of this subtitle is not needed to protect shippers from the abuse of market power.” 49 U.S.C. § 10505(a) (Supp. V 1981).

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Act “as an avenue to *decreased* regulation.”⁶⁵ The court emphasized that “[t]he notion behind deregulation is that parties should be allowed to work out their economic relationships as they see fit, free from government oversight.” *Id.* Accordingly, the court struck down the ICC’s imposition of “a new regulatory framework.” *Id.* Were the Commission to re-impose price cap regulation on special access providers, it would similarly contravene the express intent of both Congress and the Commission, over more than a decade, to move away from regulation and toward a competitive market structure.

Finally, the Commission would be required to justify its departure from its prior findings with respect to the competitive nature of the special access market in particular – findings that the D.C. Circuit has already upheld. For example, the Commission made specific findings that “competitors ha[d] made considerable investment in” facilities-based competition for special access in certain MSAs, *Pricing Flexibility Order* ¶ 95, and concluded that “competition” had “develop[ed] in the marketplace,” *id.* ¶ 19. The D.C. Circuit upheld the *Pricing Flexibility Order* in its entirety. In upholding the order, the court noted the Commission’s position that its deregulatory forms “should not be viewed in isolation, but rather as an additional step along the road of greater deregulation and pricing flexibility in the interstate access market.” *WorldCom*, 238 F.3d at 460. The switch to pricing flexibility was one of “several steps” that the Commission took “[b]eginning in 1990 . . . to encourage innovation, cost-reduction, and greater efficiency by reducing regulatory strictures in favor of market discipline.” *Id.* (citing *Pricing Flexibility Order* ¶¶ 11-18). The Commission would have a much more difficult time – and a high burden – convincing this same court that a sudden reversal in course is justified, that its

⁶⁵ *Brae Corp. v. United States*, 740 F.2d 1023, 1054 (D.C. Cir. 1984) (per curiam).

predictive judgments were wrong, and that there is less competition in special access today than there was at the time of the *Pricing Flexibility Order*.⁶⁶ And this showing would be even more difficult if the Commission attempted to make such a finding based on a record that did not include competitors' own comprehensive data about their networks, services, and customers that they have traditionally withheld from regulatory proceedings.

B. The Commission Should Reject the Various Re-Regulation Proposals Commenters Continue to Raise

As Verizon and others have explained, the record here confirms that the Commission should provide incumbents with further flexibility to respond to their customers' needs – including by extending Phase I relief throughout the country so that carriers have the *option* of negotiating customized arrangements in *addition* to generally tariffed plans; eliminating restrictions on growth discounts, banded mileage pricing, and other pricing structures; and adopting additional competitive criteria for Phase II relief to take into account additional evidence of competitors' presence – and that proposals for *re*-regulation in the face of this record evidence are legally unsustainable. *See* Verizon at 45-50; AT&T at 24-26; Qwest at 4-9, 53-57. Even aside from that, the proposals to re-regulate have additional failings that provide independent bases for rejecting them.

⁶⁶ *See State Farm*, 463 U.S. at 41-42 (“A ‘settled course of behavior embodies the agency’s informed judgment that, by pursuing that course, it will carry out the policies committed to it by Congress. There is, then, at least a presumption that those policies will be carried out best if the settled rule is adhered to.’”) (quoting *Atchison, T & S.F.R.R. Co. v. Wichita Bd. of Trade*, 412 U.S. 800, 807-08 (1973)); *Fox Television Stations*, 280 F.3d at 1044-45 (remanding rule where the FCC failed to address and explain why it departed from earlier findings).

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1. The Commission Should Reject Proposals To Require Commercial Arbitration To Set Special Access Rates, Terms, and Conditions

Some commenters propose that the Commission mandate “baseball” or “final offer” arbitration to establish both price and non-price terms for special access services. *See* Global Crossing at 11-16; PAETEC at 18-21, 24-25 & Attach. A; BT Americas at 23-24. These commenters propose that a private, AAA arbitrator would choose one party’s “offer[,]” that the arbitrator’s ruling “shall be binding on the parties,” and that the prevailing party may seek to have “judgment” on the private “Arbitrator’s award . . . entered in any court having jurisdiction.” *E.g.*, Global Crossing at 16.

As an initial matter, such proposals must be rejected because the Commission has no legal authority to mandate that carriers engage in commercial arbitration under the Federal Arbitration Act (“FAA”). As the Supreme Court has repeatedly held, commercial arbitration is “a matter of consent, not coercion.” *EEOC v. Waffle House, Inc.*, 534 U.S. 279, 294 (2002) (quoting *Volt Info. Scis., Inc. v. Board of Trustees*, 489 U.S. 468, 479 (1989)). That is because “arbitrators derive their authority to resolve disputes *only because the parties have agreed in advance to submit such grievances to arbitration.*” *AT&T Techs., Inc. v. Communications Workers of Am.*, 475 U.S. 643, 648-49 (1986) (emphasis added). Mandated commercial arbitration is an oxymoron, and flatly prohibited by the FAA. Indeed, when a state commission, exercising its authority under § 252 over interconnection agreements, sought to mandate private arbitration of disputes between an ILEC and a CLEC, a federal district court flatly rejected that effort, holding that, while arbitration is permissible when it is “optional and voluntary,” mandating arbitration “conflicts with the 1996 Act” and “contravenes the principles underlying”

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the FAA. *Verizon New York Inc. v. Covad Communications Co.*, No. 1:04-CV-265 GLS/DRH, 2006 WL 278281, at *4-*7 (N.D.N.Y. Feb. 3, 2006).

Furthermore, *bona fide* commercial arbitration would eliminate the Commission's role entirely in the regulation – and, more appropriately, de-regulation – of special access services. The FAA provides for only extremely limited review of arbitration awards and only in federal court. *See* 9 U.S.C. §§ 1-14. Not only would that result be an abdication of the Commission's statutory duties under the Communications Act, but such subdelegation of those duties to private individuals outside the agency would violate the rule that “federal agency officials . . . may not subdelegate to outside entities – private or sovereign – absent affirmative evidence of authority to do so.” *USTA II*, 359 F.3d at 566; *see Verizon New York*, 2006 WL 278281, at *6 (holding that state commission's attempt to mandate private arbitration and, thereby, “to delegate final decision making authority to a third party” was “a *de facto* abdication of its responsibilities under the 1996 Act”). There is no affirmative evidence that Congress intended to permit the Commission to subdelegate its authority under §§ 201 and 202 over interstate special access rates, terms, and conditions.

Presumably recognizing this fatal flaw, these commenters propose that the “Arbitrator's decision shall be reviewable by the Commission,” though they make no effort to square this proposal with their proposal to permit entry of judgment in a federal court on the arbitrator's award itself. *E.g.*, Global Crossing at 16. To comply with the rule that the Commission cannot subdelegate its duties under the Act – and with Commission precedent⁶⁷ – the Commission

⁶⁷ *See General Motors Corp. and Hughes Electronics Corp. and The News Corp. Ltd. for Authority to Transfer Control*, Memorandum Opinion and Order, 19 FCC Rcd 473, ¶ 177 (2004)

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would have to review *de novo* the arbitrator’s determination of the proper rates, terms, and conditions for interstate special access services. As a result, the Commission, itself, would be the one directly establishing rates, terms, and conditions by selecting between the two carriers’ “final offers.” But the Commission long ago abandoned such direct involvement in rate-setting for special access services, recognizing the inefficiency in such direct regulation,⁶⁸ and commenters provide no basis for the Commission to return to such a regime.

Even aside from the fact that the Commission therefore lacks authority to impose the “final offer” arbitration that these commenters propose, the Commission should reject such proposals for the following additional reasons.

First, any rates, terms, and conditions for special access services established through final offer arbitration would have to be tariffed and would be available to other carriers. Carriers, therefore, would have the incentive to use the arbitration process to ratchet-down ILECs’ special access rates, terms, and conditions. Any “wins” by a purchaser would presumably be available to other carriers as a contract tariff. “Losses,” on the other hand, would at most affect only the arbitrating purchaser – assuming it was bound to abide by the arbitration result and could not choose to purchase instead from another available tariff. Contrary to the assertions of the commenters proposing final offer arbitration, such a one-way ratchet is not consistent with the manner in which competitive markets operate.

Second, the common carrier nature of ILECs’ TDM-based special access services raises a significant distinction with the *Hughes/News Corp. Order* that these commenters take as their

(“A party aggrieved by the arbitrator’s award may file with the Commission a petition seeking *de novo* review of the award.”) (“*Hughes/News Corp. Order*”).

⁶⁸ See, e.g., *LEC Price Cap Order*.

model. *See, e.g.*, Global Crossing at 12-13. In that case, the Commission imposed an arbitration requirement to eliminate News Corp.’s ability to use “programming withdrawal” – *i.e.*, to refuse to offer its Regional Sports Network (“RSN”) programming at all to a particular cable system – “as a bargaining tool.” *Hughes/News Corp. Order* ¶ 174; *see id.* ¶ 175 (noting that the “staff analysis has found that the allure of temporary withholding to News Corp. is substantial”).⁶⁹ Here, in contrast, ILECs have no right to use “temporary withholding” of their tariffed special access services as a bargaining tool. Nor could ILECs do so credibly in any event, given the extensive competitive fiber and intermodal offerings that Verizon and others have demonstrated have already been (or could be) deployed.

Third, although the arbitration requirement imposed on News Corp. applied only to the price that cable companies would pay for access to News Corp.’s 12 RSN offerings, and contracts would last at least three years, *see id.* ¶¶ 49 n.172, 177, the final offer arbitration proposals here would extend to all of the many facilities and services that ILECs offer in their special access tariffs; to terms and conditions, as well as rates; and arbitrated results would last for a maximum of three years (despite the current availability of longer-term agreements with higher discounts). As a result, arbitrations of special access rates, terms, and conditions would be more frequent and vastly more complicated than under the *Hughes/News Corp. Order*.

Fourth, equally misplaced are commenters’ reliance on the Commission’s initial decision, in 1996, to employ final offer arbitration in the event the Commission adjudicated the

⁶⁹ The Commission, moreover, based its decision to impose this condition on the merger in light of a “unique combination of News Corp.’s RSN programming assets and DirecTV’s nationwide distribution platform” and concluded that its existing “program access rules” would not be “sufficient to protect against the[] likely *transaction-specific* harms.” *Hughes/News Corp. Order* ¶¶ 147, 172 (emphasis added).

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terms of an interconnection agreement under 47 U.S.C. § 252. *See* Global Crossing at 13 (citing *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, 11 FCC Rcd 15499, ¶ 1294 (1996) (subsequent history omitted)). The Commission abandoned that decision before it ever conducted such an arbitration, concluding in 2001 that “[e]xperience” at the state commissions “suggests that ‘final offer’ arbitration may not always afford the arbitrator sufficient flexibility to resolve complex interconnection issues.”⁷⁰ In addition, although Congress used the term “arbitration” in § 252(b), proceedings to resolve disputes about the terms that will be included in interconnection agreements are in no sense equivalent to private, commercial arbitrations.⁷¹ Congress expressly mandated participation in such proceedings, which are before a public body – not a private individual – and provided for extensive federal court review of the state commissions’ rulings, none of which is true of private, commercial arbitration under the FAA. Finally, § 252 arbitrations are hardly a model to emulate when it comes to determinations about rates – the state proceedings were lengthy in and of themselves and engendered nearly endless litigation. The one time the Commission was tasked

⁷⁰ *Procedures for Arbitrations Conducted Pursuant to Section 252(e)(5) of the Communications Act of 1934, As Amended*, Order, 16 FCC Rcd 6231, ¶ 5 (2001); *see also* *Petition of WorldCom, Inc. Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc., and for Expedited Arbitration*, Memorandum Opinion and Order, 17 FCC Rcd 27039, ¶¶ 30-35 (Wireline Comp. Bur. 2002) (“*Virginia Arbitration Order*”) (explaining that the Commission’s staff did not use final offer arbitration in the first Commission proceeding under § 252(e)(5) to arbitrate the terms of an interconnection agreement).

⁷¹ *See Global NAPs, Inc. v. Verizon New England Inc.*, 444 F.3d 59, 70 (1st Cir. 2006) (rejecting a state commission’s claim that an “‘arbitration’ [under] § 252(b) . . . should [be] treat[ed] . . . as [an] arbitral decision[] under the FAA”).

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with rate-setting in the § 252 context, it took the Bureau 28 months to issue its *initial* decision on rates and another 20 months to issue further rulings clarifying its initial ruling.⁷²

2. *The Commission Should Reject Proposals To Return to Cost-of-Service Ratemaking*

The Commission abandoned cost-based regulation more than 15 years ago in order to sever the relationship between rates and costs and replicate the efficiency incentives of a competitive market.⁷³ The Commission recognized that a price cap system “was not only superior to rate-of-return regulation, but could also act as a transitional system as LEC regulated services became subject to greater competition.”⁷⁴ In 1997, the Commission also eliminated the sharing mechanism based on the recognition that it “severely blunts the incentives of price regulation,” and there is no policy or factual basis for revisiting that determination.⁷⁵ In the *Pricing Flexibility Order*, the Commission reaffirmed the superiority of a price cap system and also began the process of progressively deregulating high-capacity services subject to price caps, on a market-by-market basis as competition developed. *See Pricing Flexibility Order* ¶¶ 3, 11, 14-30. The Commission also has recognized that “reducing [its] regulatory reliance on earnings calculations based on accounting data is essential to the transition to a competitive

⁷² *See Petition of WorldCom, Inc. Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc.*, Memorandum Opinion and Order, 18 FCC Rcd 17722 (2003); *Petition of WorldCom, Inc. Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc., and for Expedited Arbitration*, Memorandum Opinion and Order, 20 FCC Rcd 5279 (2005).

⁷³ *See LEC Price Cap Order*.

⁷⁴ *1995 Price Cap Review Order* ¶ 64.

⁷⁵ *1997 Price Cap Review Order* ¶ 148; *see also 1995 Price Cap Review Order* ¶ 191 (“the sharing mechanism deprives LECs and their customers of the full benefits of lower prices and improved efficiency that a pure price cap scheme can offer”).

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marketplace.”⁷⁶ As the Commission’s past statements indicate, reverting to cost-based regulation would be a giant step backwards.

Nonetheless, that is exactly what various commenters propose. Although their proposals take various forms – including using TELRIC to set special access rates, “reinitializing” price caps based on an 11.25 percent rate-of-return, or reinstating the sharing requirement – they all entail a wholesale rejection of the Commission’s actions over the past 17 years. *See, e.g.*, Sprint Nextel at 7; XO *et al.* at 45; AdHoc at 23-25; ATX *et al.* at 39-43. As explained above, there is no legal basis for any such about-face, and the Commission would be unable on this record to justify to a court its abandonment of its prior conclusions with regard to special access.

In addition, using TELRIC to set rates for special access would be directly contrary to the Commission’s determinations – and rulings of the Supreme Court and the D.C. Circuit – that limit TELRIC pricing to UNEs under § 251(c)(3). The Commission has found that, for interstate services subject to the just and reasonable standard set forth in §§ 201(b) and 202(a) – which include the TDM-based special access services at issue here – TELRIC pricing would be affirmatively “counterproductive” and is “no[t] necessary to protect the public interest.”⁷⁷ Indeed, to the extent such special access services satisfy a Bell company’s obligations to provide access to loops or transport under Checklist Items 4 and 5, the Commission has made clear that “the market price should prevail” for those elements, “as opposed to a regulated rate,” and a Bell

⁷⁶ 1997 Price Cap Review Order ¶ 150.

⁷⁷ TRO ¶ 656; *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, Third Report and Order and Fourth Further Notice of Proposed Rulemaking, 15 FCC Rcd 3696, ¶ 473 (1999) (“UNE Remand Order”), *vacated and remanded*, *United States Telecom Ass’n v. FCC*, 290 F.3d 415 (D.C. Cir. 2002), *cert. denied*, 538 U.S. 940 (2003).

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company may “satisfy this standard” by offering § 271 elements at rates in “its interstate . . . tariff[s]” or through commercial agreements with other carriers.⁷⁸ The D.C. Circuit, moreover, has upheld the Commission’s “determin[ation] that TELRIC pricing was *not appropriate* . . . for elements” that are not UNEs under § 251(c)(3).⁷⁹ Indeed, subjecting special access services to TELRIC pricing would “gratuitously reimpose the very same requirements” that the Commission “eliminated” when it held, in decisions the D.C. Circuit affirmed, that such high-capacity facilities should not be made available as UNEs.⁸⁰

Mandating TELRIC pricing for special access – thereby effectively recreating UNE obligations – would thus violate Congress’s determination that “‘impairment’ [is] the touchstone” in determining which specific elements incumbents must provide as UNEs at TELRIC rates. *USTA I*, 290 F.3d at 425. In *USTA II*, the D.C. Circuit faulted the Commission for mandating unbundling at TELRIC rates everywhere when “evidence indicated the presence of many markets where CLECs suffered no impairment in the absence of unbundling.” 359 F.3d at 587. Applying those decisions, the Commission has eliminated unbundling requirements for the highest-capacity facilities and also for DS1 and DS3 facilities in certain areas of the country. In stark contrast to its decisions requiring the provision of UNEs, the Commission’s decisions

⁷⁸ *TRO* ¶ 664; *UNE Remand Order* ¶ 473. *ATX et al.* claim(at 25-29) that Verizon is acting improperly in challenging the decisions of the few state commissions that have asserted authority to set rates (normally TELRIC rates) for 271 elements. The overwhelming weight of authority holds that state commissions have no such authority – a conclusion reached by nearly 30 state commissions and five federal district courts, all of which have expressly rejected the reasoning of the Maine district court decision that *ATX et al.* cite. The most recent decision rejecting that reasoning – and the position of these CLECs – is from an Arizona federal district court, which rejected that position in no uncertain terms. *See Qwest Corp. v. Arizona Corp. Comm’n*, No. CV-06-1030-PHX (ROS), 2007 WL 2068103 (D. Ariz. July 17, 2007).

⁷⁹ *USTA II*, 359 F.3d at 589 (emphasis added).

⁸⁰ *TRO* ¶ 659.

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not to require unbundling have been consistently upheld.⁸¹ The record here shows that competition is possible (or is actually occurring) without UNEs in all the areas where demand for high-capacity services is concentrated. Effectively recreating UNEs where impairment cannot be shown – and where the “costs of unbundling,” including “an unbundling order’s impact on investment,” *USTA II*, 359 F.3d at 572, 580, are high – would directly flout those D.C. Circuit rulings, which in turn built on the Supreme Court’s ruling in *Iowa Utilities Board* that the “goal[] of the Act” is to stimulate *competition*, not to further the narrow interests of a particular class of competitors. *AT&T v. Iowa Utils. Bd.*, 525 U.S. 366, 388 (1999).

Interpreting §§ 201(b) and 202(a) to permit the imposition of TELRIC pricing would also conflict with the Supreme Court’s decision in *Verizon Communications*. Although the Court found that the Commission reasonably interpreted § 252(d)(1) in adopting TELRIC, the Court stressed that § 252(d)(1) – which provides for rates to “be set ‘without reference to a rate-of-return or other rate-based proceeding’” – is “*radically unlike* all previous [just-and-reasonable rate] statutes” and “appears to be an *explicit disavowal* of the familiar . . . rate regulation” under those other statutes, “in favor of a *novel* ratesetting” methodology. 525 U.S. at 489 (quoting 47 U.S.C. § 252(d)(1)(A)(i)) (emphases added). In addition, the Court repeatedly made clear that it was considering the reasonableness of the TELRIC methodology as applied to “bottleneck elements” – that is, those elements that the Commission had held must be provided as § 251 UNEs. *Id.* at 510, 515, 516. The Court’s conclusions preclude the use of TELRIC under statutory provisions, such as §§ 201(b) and 202(a), that lack the “radical[]” and “novel” language

⁸¹ See *USTA II*, 359 F.3d at 578-93; *Covad*, 450 F.3d at 543-48.

the Court highlighted, and as applied to elements – like special access – that the Commission found are *not* bottleneck elements when it eliminated UNE obligations for those elements.

Equally misplaced are commenters’ proposals to utilize – either for reinitializing rates or for imposing a sharing requirement – the 11.25 percent authorized return for rate-of-return carriers that the Commission established prior to the onslaught of competitive alternatives that exist today. ILECs’ investment risk has increased significantly since the Commission last authorized a unitary rate of return in 1990. The Commission recognized this in 2003, when it modified its TELRIC rules to reject the use of the 11.25 percent return as the cost-of-capital figure and, instead, to require use of a higher “cost of capital [figure that] reflect[s] the risks of a competitive market.”⁸² As the Commission noted, “prices in a competitive market would reflect the competitive risks associated with participating in such a market.”⁸³ Using the 11.25 percent figure to set special access rates today – in addition to all the other reasons to reject a return, in today’s intensely competitive market, to this inferior form of regulation, which rewarded inefficiencies and provided uneconomic incentives – would conflict with the Commission’s recognition that the risks ILECs’ face in today’s competitive markets are far different from the risks when the Commission last set an authorized return for rate-of-return carriers.⁸⁴

Moreover, reverting to some form of rate-of-return regulation would punish price cap LECs for acting on the very incentives that price cap regulation was intended to create. Price cap regulation is supposed to reward carriers with higher returns if they are able to increase efficiencies, develop new products, and reduce their costs, as long as their rates are set at or

⁸² *TRO* ¶ 680.

⁸³ *Id.* ¶ 681.

⁸⁴ *See id.* ¶ 682.

below a cap. There is no evidence here that any carrier's special access rates exceed the cap; no carrier could charge above-cap rates unless it first went through a painstaking demonstration of need that, to Verizon's knowledge, has never even been attempted. *See* 47 C.F.R. § 61.49(d). Thus, as the Commission has acknowledged, "to the extent commenters argue in favor of traditional rate of return review of special access rate changes, their quarrel is fundamentally with price cap regulation." *LEC Price Cap Order* ¶ 221. That is a quarrel that was laid to rest 17 years ago and should not be resurrected.

What is more, a flash cut in special access rates to an arbitrary cost benchmark would contravene the Communications Act. The Commission's "authority to prescribe rate reductions under Section 205(a) depends upon a finding that current rates are or will be unreasonable." *Id.* ¶ 253. Yet there is no basis upon which the Commission possibly could make such a finding, given the tremendous competition in the provision of high-capacity services including special access and the compelling evidence of declining rates and expanding output.

Finally, from a policy perspective, seizing the efficiency gains of carriers under price caps would undermine the credibility of an incentive-based system – and of Commission regulation generally – on a going-forward basis. Prescriptive rate cuts would stifle further efficiencies and innovation. *See Access Charge Reform Price Cap Performance Review for Local Exchange Carriers*, Notice of Proposed Rulemaking, Third Report and Order, and Notice of Inquiry, 11 FCC Rcd 21354, ¶ 230 (1996) ("reinitializing indices . . . could have a negative effect on the productivity incentives of the LEC price cap plan"); *see also* Taylor Supp. Decl. ¶¶ 17, 33. In short, reimposing some form of cost-based regulation of special access rates would have dramatic, long-lasting repercussions for all Commission regulatees; never again could a

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carrier make investments without the fear that the Commission might appropriate some of the rewards years down the road. *See Access Charge Reform*, First Report and Order, 12 FCC Rcd 15982, ¶ 292 (1997) (recognizing that a rate prescription would “mak[e] carriers less confident in the constancy of regulatory policies”).

3. The Commission Should Reject Proposals To Adopt an X-Factor for Interstate Special Access Services

Despite repeated judicial determinations that the Commission “failed to state a coherent theory supporting its choice of” a particular X-Factor,⁸⁵ a number of commenters urge the Commission to wade back into that thicket and adopt an X-Factor of 5.3 percent, 6.5 percent, or even one in double digits. *See, e.g.*, Sprint Nextel at 41; XO *et al.* at 45; ATX *et al.* at 43-44; Time Warner Telecom/One Comm. at 45-46; AdHoc at 23-25. The Commission should reject these proposals.

As an initial matter, these commenters overlook that, under current rules established in the *CALLS Order*,⁸⁶ the X-Factor is set equal to the rate of inflation (as measured by the Gross Domestic Product Price Index (“GDP-PI”). This means that the annual, nominal change in the price cap index – equal to GDP-PI minus X – is zero, but *not* that the X-Factor itself is zero. *See Taylor Reply Decl.* ¶ 59. The real value of the rates permitted by the caps (relative to inflation), therefore, falls each year with inflation, at between 2 and 3 percent in recent years. *See id.* ¶ 60.

⁸⁵ *USTA v. FCC*, 188 F.3d 521, 526 (D.C. Cir. 1999); *see Texas Office of Pub. Util. Counsel v. FCC*, 265 F.3d 313, 329 (5th Cir. 2001) (“The new X-Factor suffers from the same infirmity as the prior one: the FCC has failed to show a rational basis as to how it derived the 6.5 percent figure.”).

⁸⁶ *Access Charge Reform*, Sixth Report and Order in Docket Nos. 92-262 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).

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In addition, and even aside from their failure to show any need for a higher X-Factor, these commenters provide no basis for believing that a Commission-mandated X-Factor would fare any better on judicial review this time around. *See, e.g.*, AT&T at 40-42 (describing history of judicial reversals for Commission X-Factor decisions). It remains the case, as the D.C. Circuit found in 1999, that “it is not clear that ‘interstate productivity,’ as opposed to total company productivity, is measurable, or even economically well-defined.” *USTA*, 188 F.3d at 528; *see* Taylor Supp. Reply Decl. ¶¶ 55-57. Indeed, because telecommunications carriers continue to provide interstate and intrastate services using common equipment and technology, for which they incur common costs, there is no economically meaningful way to identify separate productivity growth rates for interstate and intrastate services. *See* Taylor Supp. Reply Decl. ¶ 60. Those methodological difficulties would be even more pronounced if the Commission, as some commenters urge, were to set an X-Factor for interstate special access services in particular, as opposed to interstate services generally. As Dr. Taylor explains, “interstate special access productivity growth *does not exist*.” Taylor Supp. Reply Decl. ¶ 71.⁸⁷

4. *There Is No Basis for Imposing a “Fresh Look” Requirement*

As they have in the past, some commenters urge the Commission to mandate a “fresh look” period, during which special access customers under existing discount plans or contract tariffs could terminate or renegotiate their service arrangements irrespective of the actual terms of the deal to which they voluntarily agreed, in order to benefit from any new rules adopted in

⁸⁷ The ETI approach that imputes an X-Factor in double digits is thoroughly flawed, for reasons that have been identified in the past. *See, e.g.*, AT&T at 43-44; Taylor Supp. Reply Decl. ¶¶ 71-72.

this proceeding. *See* PAETEC at 21-23; *XO et al.* at 46-48; *ATX et al.* at 51-52. There is no policy or legal basis for granting this request.

A fresh look is an “extraordinary remedy” available only in “limited circumstances,” which are not present here. *Direct Access to the INTELSAT System*, Report and Order, 14 FCC Rcd 15703, ¶ 118 (1999) (“*INTELSAT Direct Access Order*”). Indeed, the Commission has emphasized that fresh look is a “market disrupting remedy” that is granted only on “very rare” occasions. *TRO* ¶ 698. To avoid such disruptions, and the negative effects they have on future incentives of buyers and sellers, the Commission has created a high hurdle for customers seeking fresh-look rights. *See INTELSAT Direct Access Order* ¶ 119. The commenters’ claims here fall far short of this showing.

First, there is no evidence that ILECs have market power over special access services. *See, e.g., Verizon* at 7-13. To the contrary, ILEC special access rates have been declining even in the face of rapidly growing demand, and there are numerous intra- and inter-modal competitors wherever there is appreciable demand for special access services. Consequently, no single carrier could erect barriers to competition, whether through the use of discount plans and contract tariffs or otherwise. Customers could choose other carriers or opt not to enter into a discount plan or contract tariff at all. Moreover, these arrangements do not “lock up” customers. As *Verizon* explained, the early termination provisions in its discount plans and contract tariffs are reasonable and supported by Commission precedent. *See supra* Part I.A.2. Accordingly, claims that ILECs “force CLECs” into contracts with “significant penalties,” PAETEC at 23, are simply wrong.

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Second, providing a “fresh look” in these circumstances would be contrary to the public interest because it would eviscerate the “certainty and stability that stems from the predictable performance and enforcement of contracts” that is vital to the “long-term health of the communications market.” *Ryder Communications, Inc. v. AT&T Corp.*, Memorandum Opinion and Order, 18 FCC Rcd 13603, ¶ 24 (2003). Discount plans and contract tariffs are “most naturally viewed as a bargain containing terms that both benefit and burden its subscribers,” *BellSouth Telecomms.*, 469 F.3d at 1060, and it would be “unfair for [purchasers] to completely avoid costs they knowingly agreed to shoulder” in order to “benefit[] from . . . discount arrangements which allowed for lower costs,” *TRO* ¶ 699. For these same reasons, the Commission’s staff refused to “nullify . . . arrangements” in special access tariffs to benefit a carrier that “voluntarily . . . took advantage of discount pricing plans.”⁸⁸ In addition, a fresh look would discriminate in favor of carriers that elected to commit to plans offering the highest possible discounts, putting them in a “far better position than those [carriers] that chose to avoid early termination provisions, and to select shorter contract periods with higher prices.” *TRO* ¶ 699.

For these reasons, allowing customers to terminate special access contracts would be “disruptive to the market place, and ultimately inconsistent with the public interest.” *Id.* ¶ 694. In fact, a fresh look would simply motivate ILECs to offer less aggressive discounts going forward, out of concern that customers will again be permitted to walk away from their agreements before the ILEC has recovered the costs of providing service. After all, as the Commission has recognized, early termination provisions are “a valid *quid pro quo* for the rate

⁸⁸ *Virginia Arbitration Order* ¶ 348.

reductions included in long-term plans.” *Ryder Communications*, 18 FCC Rcd 13603, ¶ 33. Without such provisions, discounts are harder to justify from the carrier’s perspective as an economic matter.⁸⁹

5. *The Commission Should Reject Commenters’ Additional Proposals for Re-Regulating Special Access*

Various commenters, in their efforts to obtain lower rates despite the extensive record evidence of competition, propose a variety of further “reforms,” all of which the Commission should reject. Indeed, many of these are directly contrary to decisions the Commission has already reached in other proceedings and are not properly part of this proceeding.

For example, ATX *et al.* argue (at 47-49) that the Commission should establish price cap baskets for DSL and other mass-market broadband services. The Commission, of course, has repeatedly *deregulated* these services, eliminating unbundling obligations for mass-market broadband services in the *Triennial Review Order*, forbearing from any obligations that might exist as to such services under § 271 in the *271 Broadband Forbearance Order* and, most recently, in the *Wireline Broadband Order*, classifying such services as information services that can be sold on a private carriage basis entirely outside of Title II regulation. The Commission has done so because mass-market broadband services are intensely competitive, with competition

⁸⁹ The one instance the commenters cite in which the Commission provided a limited fresh look involved the grant of new expanded interconnection rights that did not exist at the time existing contracts were formed; even then, the Commission imposed only a narrowly limited fresh look. *See, e.g., Expanded Interconnection with Local Telephone Company Facilities*, Memorandum Opinion and Order, 9 FCC Rcd 5154, ¶ 197 (1994); *Expanded Interconnection with Local Telephone Company Facilities*, Second Memorandum Opinion and Order on Reconsideration, 8 FCC Rcd 7341, ¶ 21 (1993). That situation is far removed from the one the Commission faces here, where no substantive rights are on the table and carriers already have the option to select from a wide range of ILEC offerings (including shorter- and longer-term deals, month-to-month rates, or contract tariffs) and from a multitude of other competitive sources.

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not only from the cable modem providers, but also from numerous intermodal providers, including wireless, satellite, and broadband over powerline, among others. Indeed, even *ATX et al.* grudgingly concede (at 46-47) that such services are “fiercely price competitive.” In light of such intense competition and the Commission’s deregulatory efforts, consistent with Congress’s directives in the 1996 Act,⁹⁰ there is no possible basis to impose new regulation on such services.⁹¹

Similarly, Time Warner Telecom argues at length (at 26-28, 42-47) about ILECs’ Ethernet services, but these services, too, have been largely deregulated as a result of past Commission decisions.⁹² But the record shows that Time Warner Telecom is currently successfully competing using its own facilities in providing Ethernet services, which in any event are not a separate product market but one of many high-capacity services from which enterprise customers can choose. Indeed, earlier this month Time Warner Telecom announced that it “is delivering more than 10,000 retail Ethernet service ports to enterprise customers locally and nationally over its national backbone and metro fiber optic network.” Embarq Attach. 3, at 1. And Time Warner Telecom’s comments here make clear that it is providing those ports over its own network and, indeed is **[Begin Time Warner Telecom Confidential]**

[End Time Warner Telecom

⁹⁰ See 47 U.S.C. §§ 157 note, 230(b).

⁹¹ *ATX et al.*’s mere speculation (at 48) about supposed possibilities for cross-subsidization does not come close to carrying the extremely heavy burden that proponents of new regulation of broadband services face.

⁹² In addition, the deemed grant, in March 2006, of Verizon’s forbearance petition further deregulated Verizon’s Ethernet services.

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Confidential] *See id.* at 38, 42. Such record evidence cannot support the imposition of new regulations.

BT Americas proposes (at 22-23) that the Commission adopt “functional separation,” which BT’s regulator in the United Kingdom has apparently recently imposed. Irrespective of whether such regulation is a reasonable response to the market facts in the United Kingdom, such separation is clearly unwarranted on the facts that exist in the United States, as shown on the record here. The Commission, moreover, has recognized the “significant[] . . . costs” and “inefficiencies” that can result from such separation rules and that can – as here – “outweigh any potential benefits of enforcing” such rules.⁹³ Nothing on the record here would support imposing those additional costs on ILECs.

⁹³ *Section 272(b)(1)’s “Operate Independently” Requirement for Section 272 Affiliates*, Report and Order in WC Docket No. 03-228, Memorandum Opinion and Order in CC Docket Nos. 96-149, 98-141, 01-337, 19 FCC Rcd 5102, ¶¶ 9, 31 (2004); *see also Wireline Broadband Order* ¶ 83 (describing the Commission’s rejection of separation requirements in *Computer III*).

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CONCLUSION

The Commission should further relax regulation of special access rates as discussed above and in Verizon's opening comments.

Respectfully submitted,



Edward Shakin
Sherry A. Ingram
VERIZON
1515 N. Courthouse Road
Suite 500
Arlington, VA 22201-2909
(703) 351-3065

Michael E. Glover
Of Counsel

Evan T. Leo
Scott H. Angstreich
KELLOGG, HUBER, HANSEN, TODD,
EVANS & FIGEL, PLLC
1615 M Street, N.W.
Suite 400
Washington, D.C. 20036
(202) 326-7930

August 15, 2007

ATTACHMENT A

**SUPPLEMENTAL REPLY DECLARATION OF
WILLIAM E. TAYLOR ON BEHALF OF VERIZON**

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

In the Matter of)	
)	
Special Access Rates for Price Cap Local)	WC Docket No. 05-25 &
Exchange Carriers)	RM No. 10593
)	

**Supplemental Reply Declaration of
William E. Taylor
On Behalf of Verizon**

I. Qualifications and Overview

1. My name is William E. Taylor. I filed a Declaration in this Docket on June 9, 2005, which listed my credentials and a Supplemental Declaration on August 8, 2007 that updated my earlier filings.¹ I have been asked to respond to economic issues raised in the August 8 filings of other parties, particularly Sprint Nextel Corporation² and the AdHoc Telecommunications Users Committee.³
2. A central question in evaluating the performance of the special access pricing flexibility regime is whether competition has been effective in constraining prices for special access services. As the NPRM states, an important element of this assessment is what has happened to price levels: “[I]f a market is (or is presumed to be) competitive *ex ante*, the level of competition can be assessed by determining whether there have been *substantial* and

¹ Declaration of William E. Taylor on Behalf of Verizon, In the Matter of Special Access Rates for Price Cap Local Exchange Carriers and 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 No. 10593), June 9, 2005 (“Taylor Declaration”). Supplemental Declaration of William E. Taylor, August 8, 2007 (“Taylor Supplemental Declaration”).

² Declaration of Bridger M. Mitchell on Behalf of Sprint Nextel Corporation (“Mitchell Declaration”), Comments of Sprint Nextel Corporation (“Sprint Nextel Comments”), and Exhibit 2 to the Sprint Nextel Comments (“ETI Update”).

³ Comments of the AdHoc Telecommunications Users Committee (“AdHoc Comments”). Appendix 1: “Special Access Overpricing and the US Economy,” (“ETI Overpricing Study”), and Appendix 2: Declaration of Susan M. Gately (Gately Declaration).

sustained price increases.”⁴ Of course, (1) special access services can be complicated, with potentially many separate rate elements, (2) the prices actually *paid* for any product include discounts that suppliers offer, and (3) there has been substantial use of such discounts under the price flexibility regime. Therefore, the FCC’s question is not whether you can find some list prices that might be higher in areas where carriers have exercised pricing flexibility, but whether the amount customers actually pay, after taking into account discounts offered by suppliers, reflects substantial and sustained price increases. The answer is a resounding “no.” As I explained in my initial Declaration [¶¶ 37-45], the prices customers actually pay for these services have continued to decline during the period in which carriers and customers could take advantage of Phase I and Phase II price flexibility and at a faster rate than prior to pricing flexibility. Moreover, any limited exercise of upward price flexibility in areas with Phase II flexibility for the tariffed month-to-month services has not produced anything resembling substantial and sustained price increases. On the contrary, prices actually paid by customers in those areas have continued to decline. These results continue to hold as the data are updated in my Supplemental Declaration [¶ 24].

3. The major dispute among economists in this proceeding is in interpreting the historical data for special access prices. There appears to be no dispute that special access customers pay—and continue to pay—substantially less per unit of capacity (*e.g.*, voice-grade equivalent line) over time. These price reductions occur on average across all special access services, across all DS-1 and DS-3 services independently, and within DS-1 and DS-3 services, across channel termination and channel mileage prices separately. On the other hand, several parties calculate other measures and comparisons of special access prices and conclude generally that competition does not constrain ILEC special access prices so that pricing flexibility has permitted ILECs to raise prices above a competitive market level. What must be determined in this dispute is whether these seemingly contradictory pieces of evidence are indicative of markets in which competition constrains the ILECs’ prices to competitive market levels.

⁴ *In the Matter of Special Access Rates for Price Cap Local Exchange Carriers and AT&T Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, WC Docket No. 05-25 and RM-10593, Order and Notice of

4. Although the Public Notice seeks considerable information in its review of special access pricing flexibility, that there have been no substantial price increases makes much of that information superfluous because its primary relevance would be in improving the current regime in the event that it were *not* working. The reason is simple. Issues such as the effects of recent mergers, of changes in technology and costs, and of the definition of the product market are merely means of determining whether the exercise of market power is possible. But since the essence of market power is the ability to raise prices above competitive levels, the demonstration that price increases that would indicate the presence of market power have not been detected indicates that the current mechanisms, in fact, are working. If any further investigation is needed, it would be to determine whether the current approach is *too* restrictive.
5. Three related additional topics arise in the comments which require some economic response. First, the familiar issue of the magnitude of ARMIS rates of return for special access services permeates the comments of parties seeking to turn back the clock to more restrictive forms of regulation. Second, using that anomalous rate of return, AdHoc calculates the special access price decrease required—in its opinion—to reduce the ARMIS special access rate of return to a previously-authorized level, assumes that price reduction represents a costless reduction in the production costs of American industry, and uses a macroeconomic forecasting model to translate that cost reduction into reductions in U.S. gross domestic product and employment. Third, ETI purports to calculate recent productivity growth for ILEC special access services and to translate that productivity growth into a proposed value of the parameter “X” in a price cap plan where regulated special access price changes would be capped by an index which fell each year by inflation minus X.
6. While these three topics appear to be unrelated, in fact, the bizarre results AdHoc reports in each case⁵ derive from the same fundamental error: the use of ARMIS investment and expense data to measure costs and rates of return for the interstate special access category.

Proposed Rulemaking, released January 31, 2005 (“*NPRM*”) at ¶ 73. Emphasis in the original, footnote excluded.

⁵ That is, (i) a 50 percent rate of return for interstate special access services, (ii) reductions in U.S. GDP of \$25 billion per year and a loss of about 200,000 jobs, and (iii) an X factor of 16.95.

Using accounting data—particularly accounting data whose economically arbitrary allocation factors were frozen at 2000 levels—to calculate a rate of return to identify the presence of market power, then flowing these ARMIS category-level rates of return into a macroeconomic model or a TFP study simply puts different shades of lipstick on the same pig. The assignments of expenses and investment to the special access category in ARMIS have no economic validity, and the pattern of sharply increasing rates of return for some categories and sharply decreasing rates of return for others is simply a consequence of rapid changes in demand coupled with artificially small changes in investment and expenses.

II. Special Access Prices Have Fallen

7. In my Supplemental Declaration I updated my previous findings that average revenue per unit for special access services has continued to fall, as the demand for those services has increased.⁶ These price reductions continued and even accelerated as ILECs began to receive Phase I and II pricing flexibility for special access channel terminations and channel mileage in various MSAs beginning in 2001. On average, special access prices fell faster during the pricing flexibility period than would have been required by the price cap annual adjustment formula. For specific services, prices for DS-1 and DS-3 services (treated independently) fell on average, as did prices for DS-1 and DS-3 channel terminations and channel mileage services, again treated separately. Hence, these results are similar to those reported in my 2005 Declaration. They show that average revenue per unit has continued to fall in the aggregate and for DS-1 and DS-3 circuits specifically. There is no evidence of the “substantial” and “sustained” price increases of which the Commission sought information in paragraph 76 of its 2005 NPRM.
8. Oddly, commenters objecting to special access pricing flexibility have presented almost no evidence regarding price increases over time. The pricing evidence that supposedly

⁶ Average revenue per voice-grade equivalent circuit is a proper measure of the price that customers actually pay for the special access service they receive. If customers shift to lower-priced contract services, they will pay less for a unit of service, which, to them, is effectively a reduction in the price the ILEC charges for the service.

contradicts the findings in the previous paragraph consists almost entirely⁷ of cross-section evidence, *i.e.*, contemporaneous comparisons of tariffed prices for month-to-month, one year, three year and five year contracts in Phase II pricing flexibility areas with UNE prices or with prices for comparable services in price cap areas at the same point in time. However, the facts concerning increases in tariffed special access prices are quite different. Verizon has not raised its tariffed prices for special access DS-1 and DS-3 services in pricing flexibility areas in the Verizon East serving area, since November 8, 2001 (DS-3) and January 5, 2002 (DS-1). A few Verizon West study areas experienced DS-1 tariffed price increases in pricing flexibility areas on January 5, 2002, and the last Verizon increase for pricing flexibility tariffed prices was on July 3, 2002 for DS-1 and DS-3 services in the remaining Verizon West study areas.⁸

9. These time series and cross-section descriptions of special access pricing appear to tell different stories. On the one hand, I show that by nearly any measure of average revenue per unit, special access prices have fallen (over time) during the pricing flexibility period—indeed, they have fallen faster during that period than before—and there is no evidence that pricing flexibility has led to significant and sustained price increases. On the other hand, opposing parties assert that at particular points in time, tariffed prices for month-to-month and particular contract services are generally higher in Phase II pricing flexibility areas than in price cap areas.⁹ Reconciling these data is obviously important in interpreting the industry’s experience under special access pricing flexibility.¹⁰

⁷ The exceptions I can find in the current round of comments are references to a claim in the GAO Report [ATX at 33, XO at 15] and to a McLeodUSA petition in the Qwest Omaha Forbearance proceeding [Comptel at 7].

⁸ The suggestion that special access prices have been constrained only by price cap regulation or merger commitments is clearly wrong. In addition to constraining the prices that customers actually pay, competition has also constrained special access tariffed price increases in areas where Verizon received pricing flexibility for several years prior to the imposition of the merger conditions in January 2006.

⁹ See, *e.g.*, the Sprint Nextel Comments, Exhibit 1 or the Gately Declaration, Exhibit 2.

¹⁰ This Commission’s observations in its determination that the Verizon/MCI merger would serve the public interest when confronting similar special access pricing data is instructive:

Verizon provides special access services under tariffed rates as well as through individual contracts, as Verizon has gained pricing flexibility in certain MSAs.

10. Before undertaking that reconciliation, however, it is important not to mis-interpret the focus on price changes in this discussion. It is understandable that purchasers of special access services want lower prices and that they prefer the regulatory arrangement that produces the lowest price for the services they use. That, however, is not the standard that economists (or the Commission) should apply in appraising the Commission's assumptions regarding special access competition. Rather, in asking whether special access markets are effectively competitive, economists would ask if pricing flexibility allowed prices to move towards a competitive market level, wherever that level may be. And in industries characterized by a high proportion of fixed costs, that competitive market level must depend both on costs and demand conditions.¹¹
11. Because interstate special access prices have been pervasively regulated throughout the history of the industry, there can be no presumption that prices at the beginning of pricing flexibility necessarily reflect competitive market conditions; it may well be the case that the prices regulated for years by the Commission's Part 69 Rules would be lower or higher than prices in a competitive market equilibrium. The Commission recognized this fact in the *Pricing Flexibility Order* where it acknowledged that Phase II pricing flexibility could result in price increases that were nonetheless warranted because regulated prices could be below or above cost but in either case, the public interest was better served by permitting market

Various volume and term discounts may apply to individual purchases or for all purchases in particular regions. Other discounts are dependent on maintaining minimum purchasing levels over several years. While it is not always clear how much each buyer pays, *it is clear that the simple tariff rate sometimes used by commenters for comparing prices is not adequate for that purpose.*

In the Matter of Verizon Communications Inc. and MCI, Inc. Application for Approval of Transfer of Control, WC Docket No. 05-75, Memorandum Order and Opinion, released November 17, 2005 at footnote 114. Emphasis added, citations excluded.

¹¹ “[T]he regulatory assumption that price would be based on cost alone in a competitive market is wrong. Economic theory has developed precise conditions when price is independent of demand, and they do not hold, even as an approximation, in telecommunications.” J.A. Hausman, “Regulated Costs and Prices in Telecommunications,” in G. Madden and S. Savage, *The International Handbook of Telecommunications Economics*, Volume II, Edgar Elgar (2003), Chapter 10, p. 210.

forces to govern the rates.¹² Hence, even if real (*i.e.*, inflation-adjusted) prices had increased after Phase II relief – which is not the case – that would not contradict the Commission’s conclusion that the market is sufficiently competitive to warrant pricing flexibility.

A. Criticisms of average revenue per unit are unfounded

12. AdHoc asserts that the ILEC claim that special access prices are falling is “extraordinarily misleading” because the use of average revenue per voice-grade equivalent line means that if demand shifts towards higher-capacity services, average revenue per voice-grade equivalent will fall even though no prices may have fallen.¹³
13. This topic, of course, has been discussed at length in earlier filings in this Docket. My conclusion from the discussion is that average revenue data differ from a price index, but regardless of the differences, the data demonstrate that competition has led to circumstances in which customers paid a lower price for the services received. The important question is not whether average revenue per unit and a price index differ — they do and no one ever said they did not — but what inference should be drawn from the average revenue per unit data actually presented.
14. There are several reasons why the component of the reduction in average revenue per unit associated with customers’ shifting to discount tariffs implies that competitive market forces are controlling prices. First, the effects in the market are similar to a reduction in tariffed prices: customers can choose to pay less for essentially the same service, and the ILEC can accept less revenue for providing essentially the same service or lose the customer. Second, discount tariffs are optional offerings of the ILECs, and customers are not compelled to purchase from them. However, the fact that ILECs offer them and the bulk of customers purchase from them demonstrates the effect of market forces. Nothing in the regulatory rules compels ILECs to offer discount tariffs. Price cap regulation during this period required ILECs to reduce tariffed prices for special access services according to the price cap formula,

¹² *Access Charge Reform*, CC Docket Nos. 96-262, 94-1, 98-63, 98-157, Fifth Report and Order and Further Notice of Proposed Rulemaking, 14 FCC Rcd 14221 (1999) (*Pricing Flexibility Order*) at ¶ 155.

but shifts in demand from month-to-month service to discounts and contract tariffs by themselves do not reduce the ILEC's actual price index ("API").¹⁴ Thus, the presence of competition sufficient to exert pressure on the prices actually paid by customers and received by suppliers can be inferred from the presence and magnitude of the shift to discount tariffs.

15. If year-over-year demand shifts from buying services at list prices to purchasing them at a discount price, that shift will result in a lower average service price, even if neither the list price nor the discount price changes.¹⁵ And such a reduction in the calculated price index makes economic sense. When competition increases, list prices such as commercial real estate rental prices or retail auto prices may remain the same, but sellers are obliged to compete through bargaining by lowering the actual prices at which transactions take place. To say that a lower average price stemming from such a shift in demand is not a price reduction is to elevate form over economic substance.
16. AdHoc asserts [Appendix 3, A-24] that special access demand growth is higher for higher-capacity services. Since higher bandwidth services are uniformly priced lower (per voice-grade equivalent) than lower bandwidth services, such a shift in demand would reduce the average revenue per voice-grade equivalent charged by the supplier and paid by the buyer, even though the underlying service prices are unchanged. To deal with this assertion as a

¹³ Appendix 3 ("The FCC's Flawed Approach to Evaluating Competitive Conditions") to Appendix 1 ("Special Access Overpricing and the US Economy") to Comments of the AdHoc Telecommunications Users Committee, at A-24.

¹⁴ According to § 61.46 of the Commission's Rules, the API is a revenue-weighted average of the year-over-year price changes for each service, where the revenue weight for the i^{th} service is calculated using base period demand and existing prices. Thus, the effects of shifts in demand on the API is to shift the weights given to different year-over-year changes in price for the different services. The fact that demand might shift to a discount tariff service from a month-to-month service thus would not reduce the API.

¹⁵ A properly calculated chain-linked Laspeyres price index — of the type used by the Bureau of Labor Statistics — captures such shifts in demand by distinguishing between the list price and the price at which services are actually sold. For example, when an automobile manufacturer offers a rebate, the value of the rebate is subtracted from the reported price of a vehicle. Similarly, when grocery stores offer discounts, e.g., in the form of extra volume in a tube of toothpaste or discount coupons for selected items (or customer types), the prices recorded by the BLS account for such discounts. *BLS Handbook of Methods*, Chapter 17, "The Consumer Price Index," pp. 31-32, downloaded on October 21, 2005 from <http://www.bls.gov/opub/hom/pdf/homch17.pdf>

threshold matter, I calculated average revenue per voice-grade equivalent separately for DS-1 and DS-3 services, which eliminates any effect of shifts in demand towards higher bandwidth services. Thus, while shifts in demand from higher-priced per unit, low-bandwidth services to lower-priced per unit, high-bandwidth services can, in theory, cause average revenue per unit to fall, such shifts are not an explanation for the observed reductions in average revenue per voice-grade equivalent line.

17. AdHoc also claims [Appendix 3, footnote 88] that ARMIS special access voice-grade equivalents overstate the relevant number of access lines because it assumes “100% utilization of the facility despite the fact that the economic crossover point is considerably lower” so that ARMIS average revenue per voice-grade equivalent would understate—in an example, by a factor of 7—the relevant price per voice-grade equivalent. Thus, for example, a customer who “wants” 12 DS-0s but finds a DS-1 cheaper is assumed to purchase 24 DS-0s so that the average revenue per voice-grade equivalent would be artificially reduced.
18. There are obvious problems with this argument. First, the *level* of average revenue per voice-grade equivalent line does not arise in my analysis. The points I raise all deal with the *rate of change over time* in average revenue per voice-grade equivalent line. Thus, a consistent bias in the measure of average revenue per voice-grade equivalent line (if there were one) would have no effect on the results.
19. Second, AdHoc’s claimed overstatement of DS-0 equivalent access lines for DS-1s and DS-3s that are provided without individual circuit termination is peculiar. If a customer buys a DS-1 but only needs 12 DS-0-worth of capacity, what is the number of DS-0s purchased for the price of the DS-1? AdHoc asserts that the correct number — for calculating prices — is 12. Since the ARMIS instructions require 24, AdHoc claims that the number of DS-0 equivalents is overstated, so that the average revenue per DS-0 is understated. But this claim embodies a strange notion of price. If I buy a dozen eggs for \$3.60 when I only need six, the price (per egg) is still \$0.30, not \$0.60.¹⁶ Whether I *use* the full capacity of the DS-1 that I buy without individual circuit terminations is irrelevant as well as impossible to measure. It is irrelevant because I am purchasing DS-1 capacity that the carrier must make available to

¹⁶ Assuming I throw away the extra six eggs, the transaction does show that I would be willing to pay \$0.60 per egg, but the price remains \$0.30.

me whether I use it or not. Even if I “want” only 12 DS-0s, 24 DS-0s-worth of capacity will be dedicated to my (actual or potential) use. Usage is impossible to measure because demand for capacity varies over time. For example, consider a data application in which 1 DS-0 is more than sufficient for 23 hours a day with 12 DS-0s required for the 24th hour. This customer obviously requires at least 12 DS-0s of capacity but on average “uses” only 1.46 DS-0s.¹⁷

B. Price differences between pricing flexibility and price cap areas are consistent with effective competition

20. Several parties compare tariffed ILEC special access prices for month-to-month, and one, three and five year contracts between MSAs subject to Phase II (complete) pricing flexibility and price caps. They assert that these tariffed prices in areas with Phase II pricing flexibility are generally higher than prices in areas still subject to price caps and conclude from those comparisons that ILEC prices are not constrained by competitive forces.¹⁸ The conclusion does not follow from the evidence.
21. As measured by the FCC’s triggers, pricing flexibility areas are expected to exhibit greater competition for special access services than other areas. Some parties (including the GAO Report) conclude from this observation that prices should be lower or fall faster in MSAs subject to pricing flexibility than in price cap MSAs. Even if competition is actually more vigorous in pricing flexibility MSAs, it does not follow that prices will be lower or fall faster in those MSAs than in other areas.
22. First, where ILECs are granted Phase I pricing flexibility, they are able for the first time to selectively reduce prices by means of contract tariffs and responses to RFPs. All else equal, then, reclassifying an area as subject to Phase I pricing flexibility should result in rates that are either unchanged or lower. Higher rates should not be expected as a consequence of regulatory reclassification because no additional regulatory flexibility was granted in those areas to raise rates. In contrast, for Phase II pricing flexibility, the additional flexibility granted (above that in Phase I areas) was the ability to raise prices. Again, all else equal, one

¹⁷ $1.46 = [1 \times 23/24] + [12 \times 1/24]$

¹⁸ For example, see Mitchell Declaration ¶¶ 48-58; Sprint Nextel Comments, Exhibit 1; ATX, Attachment 4, XO, Attachment 2; Gately, Exhibits 1 and 2.

would expect the effect of *the regulatory reclassification* would necessarily be to increase rates. The regulated firm was able to reduce rates before the reclassification, and the only effective change from reclassification to Phase II pricing flexibility is the ability to raise prices that would otherwise (under price caps or Phase I pricing flexibility) be forbidden. Thus, we would not be surprised to find that (over time) price reductions were slower — or (across MSAs) that tariffed prices were generally higher — in Phase II MSAs than in Phase I MSAs. And such a finding would tell us nothing about whether competitive forces were constraining special access prices. Similarly, the comparison between prices under Phase II pricing flexibility and price caps is ambiguous: it is undetermined whether the new regulatory flexibility to reduce prices under Phase I flexibility outweighs the new regulatory ability to raise prices under Phase II flexibility.

23. Second, the fact that the MSAs subject to Phase II pricing flexibility may be more competitive than other MSAs does not imply that prices would be more likely to fall in those MSAs. That belief requires the further assumption that the initial regulated special access prices exceed competitive market levels, and there is no evidence that this is the case.
24. Third, all else is never equal. At the same time as MSAs attain Phase I or Phase II pricing flexibility, ILECs are offering discount contract tariffs, and customers are shifting demand toward those contracts. Recent estimates suggest that on the order of about 90 percent of Verizon's special access revenue from carrier customers now derives from services purchased from these tariffs and other discount plans, which offer discounts of 50 percent and more off of tariffed month-to-month rates.¹⁹ The result of this shift in demand has been a reduction in the prices customers actually pay, even though the month-to-month or any individual contract tariff price may have stayed the same or increased. And, since the *additional* flexibility provided by Phase II pricing flexibility is the ability to increase rates, one should not ascribe any of the reduction in average prices paid by customers to the reclassification as Phase II. Nonetheless, the same underlying competitive conditions that cause an MSA to be reclassified as Phase II also underlie each ILEC's decision to offer

¹⁹ See Declaration of Quintin Lew, In the Matter of Special Access Rates for Price Cap Local Exchange Carriers, WC Docket No. 05-25, June 9, 2005 at ¶62 (“Lew Declaration”), SBC Comments at 22, BellSouth Comments at pp. 17-19.

discount plans voluntarily. After all, if there were no competition in these MSAs, it is unlikely that reducing prices through contract tariffs would be a profitable pricing strategy.

C. Differences between pricing flexibility prices and UNE prices are consistent with effective competition

25. Some parties use UNE prices or TELRIC costs as a measure of forward-looking costs and thus as a standard for competitive market pricing of special access services.²⁰ There are two problems with this standard: (i) TELRIC and UNE prices are not reasonable estimates of the ILEC's forward-looking economic cost of providing special access service and (ii) forward-looking economic cost is not a good measure of the competitive market price for special access services. The Commission likewise recognized as much for switched access when it chose to use market forces rather than regulated TELRIC costs to determine the ultimate level of switched access prices.²¹
26. First, TELRIC-based prices do not approximate competitive market prices in principle because no firm can remain in a market characterized by technical change if it must price its services at each instant at the lowest cost attainable by a hypothetical perfectly efficient entrant. Moreover, in practice, TELRIC-based rates do not account for the option value implied by the sunk investment costs of a wireline network, in which CLECs can buy services on a month-to-month basis while ILECs must make sunk investments to provide the facilities. Second, even if TELRIC approximated an ILEC's forward-looking economic cost (which it does not), prices in effectively competitive markets are not always determined entirely by cost. In fact, where fixed costs are an important proportion of total costs, competitive market prices will generally depend on both prices and demand.²²

²⁰ See, e.g., Mitchell Declaration ¶¶ 57-58, ATX Attachment 4 and XO Attachment 2.

²¹ FCC, *In the Matter of Access Charge Reform* (WC Docket No. 04-313), *Price Cap Performance Review for Local Exchange Carriers* (CC Docket No. 94-1), *Transport Rate Restructure and Pricing* (CC Docket No. 91-213), and *End User Common Line Charges* (CC Docket No. 95-72), First Report and Order, released May 16, 1997 at ¶ 263 (“Access Charge Reform Order”)

²² See Hausman, *op. cit.*

D. Differences between the ILECs' APIs and PCIs²³ do not indicate the presence of market power

27. Sprint Nextel attempts (at 20) to infer from the fact that Verizon's and AT&T's APIs closely tracked their required PCIs for the 2007-2008 tariff year that price cap regulation and not competition has been driving their actual special access prices. That inference is not generally warranted. First, if the *annual price reductions* imbedded in the PCI exceed the market's reduction in unit costs or if, for any reason, the *initial level* of ILEC special access prices is below the competitive market level, the reductions required by the PCI will be a binding constraint on the ILECs irrespective of the level of competition. Hence, one cannot infer that competitive forces are not binding on special access prices simply because the actual rate reductions equal those required by price cap regulation. To reach Sprint Nextel's conclusion, one must also assume that special access prices exceed the competitive level and that unit costs are falling more rapidly than the PCI.
28. Second, the form of regulation in specific MSAs did not remain unchanged over the period. The PCI only applies to those areas where ILECs have not qualified for Phase II price relief. It is only in those areas that Sprint Nextel's comparisons (over time) of the API and PCI are calculated. Thus, one cannot conclude that competition as measured by the FCC's triggers has failed to constrain prices because the calculation ignores prices in those areas where competition is most developed.
29. Third, as explained above in footnote 14, shifts in demand from month-to-month service to contract tariffs by themselves do not reduce the ILEC's API. Thus, as competition and customer preferences shifted demand towards discount plans and contract tariffs, some portion of effective ILEC price reductions were not credited towards meeting the PCI. Hence, the observation that ILEC APIs closely tracked their PCIs does not imply that the PCI was a binding constraint on ILEC special access prices.

²³ Under the Commission's price cap regulatory rules, the actual price index (API) for a basket of services cannot exceed the price cap index (PCI) for that basket.

E. Special access prices have not increased over time

30. Several parties²⁴ cite the GAO Report as support for the propositions that tariffed prices for special access month-to-month and one, three and five year contract services have increased over time in Phase II areas and are higher in Phase II areas than in Phase I or price cap areas. Two aspects of this Report are germane here. First, as discussed above, it ought not to be surprising that some special access tariffed prices have fallen more slowly or are higher at some point in time in Phase II areas than in Phase I areas. When an ILEC is granted Phase I relief in a particular MSA, the ILEC is able to reduce prices through responses to RFPs and the offering of contract tariffs. When a Phase I MSA is classified as Phase II, the only change in the regulatory environment is to permit the ILEC to increase prices if it chooses to do so. Thus, a comparison of prices or price changes between Phase II and Phase I MSAs includes an important difference in regulatory flexibility in addition to whatever differences there may be due to competition. The fact that the bulk of Verizon customers purchase services through discount plans—which Verizon is not obligated to offer—implies that competition constrains prices.

31. Second, it is important to recall that the GAO Report did not conclude that customers have paid more for special access services under pricing flexibility. Rather, the report concluded that

Average revenue for channel terminations and dedicated transport for DS-1 and DS-3 has generally decreased over time, although the decline in average revenue for channel terminations is larger in phase I areas compared with phase II areas. Comparing average revenue across price-cap areas, phase I areas, and phase II areas as of 2005—the most recent period available—we found that average revenue in the 27 phase II areas is higher, on average, than it is in the 29 phase I areas and not statistically different than average revenue in areas that are still under a price cap.

This conclusion is emphatically *not* a finding that pricing flexibility has led to significant and sustained price increases.

²⁴ See , e.g., Mitchell Declaration ¶¶ 52-52.

F. Average revenue and tariffed prices

32. These measures of price changes appear to give rise to a paradox: the GAO Report asserts that prices in areas with complete pricing flexibility are higher than the corresponding prices in areas still subject to price caps, but I find that unit revenue fell on average faster than required by the price cap formula. Consider the following example that illustrates why unit revenue can be lower after pricing flexibility was available than before, even though tariffed rates in pricing flexibility areas may be higher than in price cap areas.
33. Suppose two baseball players are competing for a major league batting title. The following table displays their performance during the first and second half of the season.

Table 1.

	First Half			Second Half			Season		
	At Bats	Hits	Average	At Bats	Hits	Average	At Bats	Hits	Average
Bill	300	110	0.367	300	90	0.300	600	200	0.333
Bridger	200	74	0.370	300	92	0.307	500	166	0.332

In this example, Bridger has a higher batting average in each half of the season, but Bill has the higher overall average and therefore wins the batting crown. That is, focusing on the results for each half-season leads to the wrong conclusion for the entire season.²⁵ And the reason for this is that Bill had relatively more at-bats in the first half, when averages were higher.

34. For special access services, the increase in competition has led to greater use of discounts and greater discount levels off the standard month-to-month tariff rates. And even though a customer that would qualify for such a discount might have paid less in a price cap area at any point in time, the competitive process has resulted in relatively more such customers

²⁵ Despite some parties' claims that tariffed prices for month-to-month and one, three and five year contract services in areas with complete pricing flexibility are purportedly higher than the corresponding prices in areas still subject to price caps, my finding that unit revenues have fallen faster after pricing flexibility than required by the price cap formula cannot be rejected as invalid. The baseball example shows that the mere existence of such inconsistencies between results for subgroups and the entire population does not necessarily mean that the overall result is incorrect.

taking advantage of discount plans during the period in which pricing flexibility has been available. And because of the greater use of discount offers and the greater range of options that provide larger effective discounts, customers do pay less on average under pricing flexibility. Just as Bill's greater activity in the first half of the season (when averages were higher) resulted in his winning the batting title, the greater discount activity under the price flexibility regime results in winning the race of providing customers with the cheapest service.

G. Conclusion

35. In short, the lesson from competition for special access services is that incumbents and entrants do not generally compete by simply lowering prices of existing products. Rather, competitors find it more profitable to compete by offering new products, including packages of existing products, negotiated term and volume contracts and discounts that may lead to lower average revenue per unit for the firm but which may induce customers to commit to spend more in total or over a longer time period with the firm. Such competition is effective in the sense that it constrains the ability of incumbent firms to raise prices, but its effects cannot be measured accurately by charting the course over time of individual month-to-month and one, three and five year contract prices.

III. Market Definition Issues

36. The Mitchell Declaration [¶¶ 15-25] asserts that substitution possibilities are limited between facilities of different bandwidths so that DS-1 and DS-3 services are supplied in distinct product markets. Similarly, he states [¶ 14] that channel terminations and channel mileage are in separate relevant [product] markets and that channel terminations and channel mileage are more likely complements than substitutes. Finally, Dr. Mitchell [¶¶ 26-28] opines that the MSA is too broad an area to be used as a relevant geographic market and that the wire center is a useful approximation to that concept.

37. Understanding the substitution possibilities between channel terminations and channel mileage and among facilities of different bandwidth is a useful part of an examination of special access competition as is developing an understanding of the geographic extent of actual and potential competition. However, going beyond the measurement or understanding

of substitution possibilities to the exercise of defining relevant (antitrust) product and geographic markets is not useful in the current context for two reasons.

38. First, in the *Merger Guidelines* paradigm, a formal market definition is necessary only to calculate market concentration; it is not necessary to assess competition or market power. Assessing competition or measuring market power, in theory, requires only that the analyst measure the substitution among services in geographic areas that would take place in the event of a price increase. In that exercise, the analyst does *not* need to assign particular services in their entirety to the market or not. That determination – the definition of a relevant market – does violence to the obvious fact that substitution is rarely perfect on the one hand or entirely absent on the other.²⁶
39. Second, the purpose of adopting triggers for pricing flexibility (instead of an antitrust market power showing for forbearance from price regulation) was practical; by the time the analyses would be complete and the evidence assessed, market conditions would have changed. By the same reasoning, requiring more finely-tuned analyses of competition in smaller product or geographic areas would be similarly self-defeating. Even though the Pricing Flexibility Order recognizes that basing a trigger analysis for pricing flexibility on a smaller geographic area than an MSA “might produce a more finely-tuned picture of competitive conditions,” it concluded that the additional detail obtained did not justify the increased expense and administrative burden associated with additional filings.
40. That said, the fact is that special access services are often purchased as circuits, which are combinations of channel terminations and channel mileage circuits often multiplexing components of different bandwidths. The FCC’s current rules for permitting pricing flexibility explicitly address the complementary nature of the individual components linking customer locations and POPs by having separate, more rigorous standards for granting Phase II pricing flexibility for channel terminations to customer locations. Under these rules, an

²⁶ For example, Dr. Mitchell observes [¶ 21] that on dense routes with DS-3 competition, an increase in the DS-1 price could induce DS-3 providers to channelize additional capacity to provide more DS-1 service. However, he concludes for various reasons that DS-1 and DS-3 circuits are in different product markets. Obviously, an increase in the DS-1 price would induce some entry from DS-3 suppliers, and that substitution is lost when one first defines a relevant market and then considers substitution possibilities.

ILEC could be granted flexibility for transport (and entrance facilities), but would still be subject to price caps for channel terminations.

41. Further, in theory, when competitive conditions result in prices higher than marginal cost, *e.g.*, in order to recover shared and common costs associated with pervasive scale and scope economies, *additional* competitive pressure, which further constrains market power, is placed on the prices of each of the complementary goods. For example, an increase in transport prices could produce losses not only to the ILEC's transport volumes, but also in the sale of channel terminations connecting customer locations. And to the extent that there are incremental profits in providing channel terminations, the potential loss of such profits can make attempts to charge supracompetitive transport prices unprofitable.

IV. Rate of Return and ARMIS issues

42. Several parties continue to argue that high regulatory accounting rates of return for interstate special access services imply that prices are too high and that the ILECs possess market power. The economic responses to most of these claims were laid out in my Supplemental Declaration (at ¶¶ 38-44) and my Reply Declaration (at ¶¶ 12-19), and I will not repeat them here. ATX (at pp. 11-13) and AdHoc (at Appendix 1 "RBOC 'Explanations' for their Excessive Earnings on Special Access Services") raise some issues that I did not address previously.
43. First, ATX asserts (at p. 12) that ARMIS data "is showing such high rates-of-return that no amount of tweaking would show that the BOCs are not earning unconscionable rates-of-return." This argument makes the fundamental mistake of assuming that there is an economically meaningful rate of return for interstate special access services. The problem is not that ARMIS contains errors that, if fixed, would produce a meaningful rate of return. Rather, a firm that produces services that are regulated and unregulated, jurisdictionally interstate and intrastate, access and non-access, and switched and special access using shared fixed and common facilities *cannot* calculate a rate of return for an individual service that makes any sense. It is not that the calculation is difficult; the thing to be calculated – a rate of return for a single service provided by a network that provides many other services using the same common facilities – does not exist. Ask a cable company what its rate of return for HBO service is.

44. Total interstate earnings from ARMIS are calculated from revenue, cost and investment data that have been passed through the Part 64 allocation and Part 36 separations processes, distinguishing regulated from unregulated costs, revenues and investment as well as, for regulated services, interstate from intrastate. Such distinctions are economically meaningless; consequently any measure derived from them, including rates of return, provides no information that can be used to evaluate the competitive conditions that ILEC special access services face.
45. Second, ATX (at 13) asserts that possible misallocations of investment and expense in ARMIS do not affect *trends* in the data because those misallocations do not change from period to period, so that the (increasing) trend in special access rates of return is a reliable indicator of market power. This argument is wrong for two reasons. First, a trend in ARMIS rates of return says nothing about a trend in an ILEC's interstate special access rate of return because that concept does not exist. And since there is no well-defined concept of an interstate special access rate of return, then a trend in an estimate of it says nothing about the competitiveness of interstate special access services. Second, ATX's basic assumption is wrong: the levels of so-called misallocations in ARMIS *do* change from period to period. The fact that separations factors have been frozen at their 2000 levels means that whatever an ARMIS-calculated rate of return for interstate special access actually measures, it does not reflect a consistent assignment of revenue, expense and investment to the special access category. As explained in my Supplemental Declaration, the relative growth in demand for special access services combined with the freeze in separations factors causes reported earnings to increase over time.
46. AdHoc gives two reasons why ARMIS does not under-allocate expenses or investment to the interstate special access category: (i) the shift towards higher bandwidth services means that investment will not grow at the same rate as voice-grade-equivalent lines, and (ii) investment for unregulated broadband services (*e.g.*, FiOS and Lightspeed) has been improperly booked to the interstate special access category.
47. Again, since there is no economically relevant quantum of investment or expense to be assigned to interstate special access services, these observations are not relevant in assessing the competitiveness of special access services. In addition, whatever ARMIS did in 2000, it

is doing something different today. ARMIS currently assigns the same proportion of certain investment and expense accounts to interstate special access that was assigned in 2000, when special access demand was a fraction of its current levels. Thus, whatever the method produced in 2000, it is producing something different today.

48. AdHoc argues that revenues from FiOS and Lightspeed are excluded from ARMIS²⁷ and that assignments of expenses and investment fundamentally caused by those services should also be excluded from the ILEC's regulatory accounts:

The sole purpose of the *FiOS* and *Lightspeed* investments is to support nonregulated broadband and video services, and these investments would not be made but for the requirements of those services. However, once built, the new broadband plant can be – *and is being* – used to provide traditional voice telephone services. [A-9]

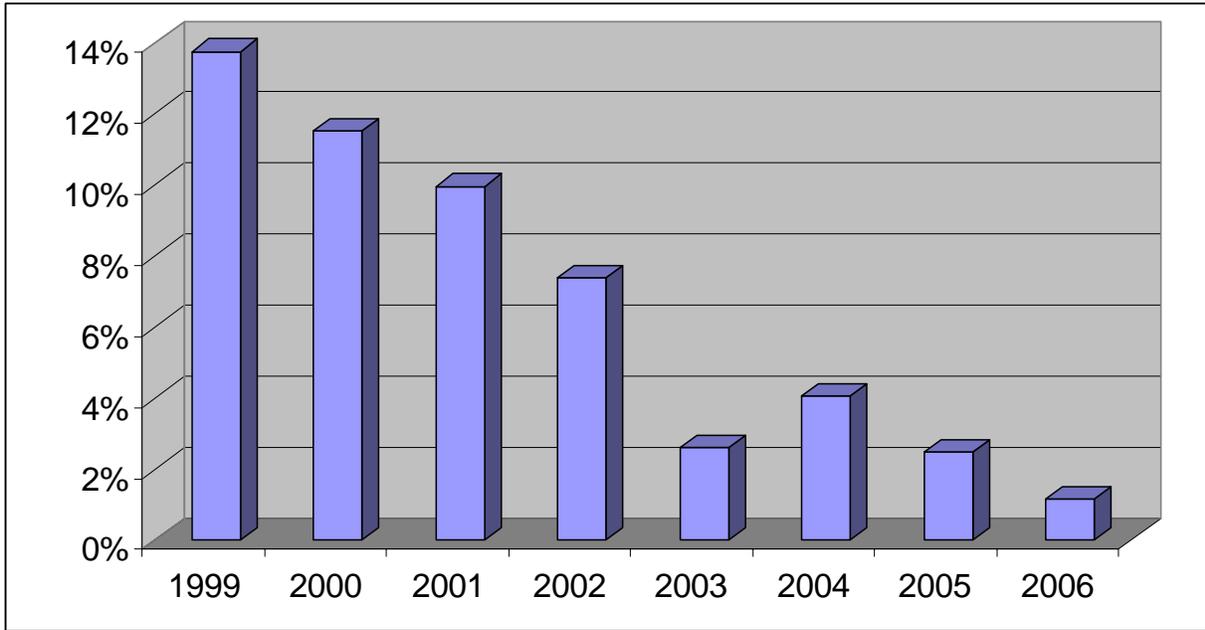
As a matter of economics, this argument is fundamentally incorrect. Efficient investment in a joint-use network requires that the firm determine the optimal network technology and architecture in which to provide all the services that customers demand. Then the economically efficient prices to charge for services are based on the respective incremental costs of and demand conditions for those services *in the optimal network*. It may be less costly to continue to provide POTS in a standalone copper network, but society as a whole is better off if voice telephony is provided in the most efficient joint-use network. And the efficient cost of telephony is its cost in that network, rather than in a standalone network dedicated to voice service. The classical example of this principle (due to Alfred Kahn) is the fenderless car: the most efficient way for society to supply such vehicles is probably to construct cars with fenders and then pay someone to remove them.

49. AdHoc [footnote 41] argues that ILECs have attempted to disown ARMIS data in other forums. Without exploring the circumstances of these statements, it is difficult to accept or reject AdHoc's claim. However, what is clear in the use of ARMIS data is that neither ETI nor any other party to this proceeding, while opposing ILEC petitions for deregulation or reclassification of intrastate telecommunications services, has presented ARMIS *intrastate* rates of return as evidence of the degree of competition for intrastate services. If the

²⁷ In fact, following the ARMIS rules, FiOS revenue is included in Verizon's ARMIS reports, but it has been removed from the data used in this proceeding.

presence of high and increasing ARMIS earnings for interstate special access services is relevant in assessing competition for interstate special access services – and I hasten to emphasize that it is not – then the presence of low and falling ARMIS earnings for intrastate telecommunications services would also be relevant in state deregulatory proceedings. Verizon’s intrastate rates of return from ARMIS data are shown in Figure 1 below.

Figure 1.
Verizon Intrastate ARMIS Rates of Return



Source: ARMIS. Taylor Supplemental Declaration, Table 9.

V. Macroeconomic Effects

50. AdHoc uses a standard macroeconomic model to trace the effects of an exogenous 53 percent reduction in special access prices in 2007, followed by roughly 6 percent additional price reductions in 2008 and 2009 for interstate special access services. According to AdHoc, these price reductions would reduce customer expenditure by about \$8 billion in 2007, followed by additional reductions of about \$1 billion in 2008 and another \$1 billion 2009. When the dust settles in this thought experiment, U.S. firms that purchase telecommunications services would spend about \$10 billion per year less to obtain the same amount of service. That reduction of \$10 billion of cost is then fed into a standard

macroeconomic model of the U.S. economy, which, according to AdHoc, shows a cumulative increase in employment in 2009 of about 234,000 and a cumulative increase in GDP of about \$66.7 billion per year.

51. These sound-byte numbers have nothing to do with special access services or economics.

The Global Insight macroeconomic model simply takes the assumed reductions of \$8, \$9 and \$10 billion per year in telecommunications expenses and flows them through the U.S. economy. In turn, those reductions were calculated by determining the reduction in special access prices and revenues necessary to drive the ARMIS rates of return for interstate special access services discussed in the previous section to 11.25 percent. This calculation and its associated input into the macroeconomic model is microeconomic nonsense. ARMIS rates of return at the category level were never intended to set prices and are particularly meaningless in 2007 after a seven year freeze in the allocation factors. All the AdHoc calculation really shows is that if \$10 billion in annual expenditure on ILEC telecommunications services could be erased without affecting telecommunications suppliers, U.S. GDP and employment would increase. And, of course, a \$10 billion annual rate reduction for high-capacity services *would* reduce the incentives to invest in broadband infrastructure to supply those services, by ILECs, wireline competitors and intermodal competitors.

52. Even on their own terms, these results make no sense. If AdHoc actually believed that ARMIS rates of return could be used as in AdHoc Appendix 1, Table 1, its policy recommendations would presumably be very different. Taking, for example, the Verizon ARMIS rates of return from Table 9 of the Taylor Supplemental Declaration, we see that a massive rate rebalancing across *all* categories would be warranted, if this method were to be taken seriously. Intrastate prices would increase radically, along with some other interstate access charges. In net, Verizon's earnings would have to rise to bring its ARMIS earnings for services subject to separations to AdHoc's assumed target of 11.25 percent. Hence, rather than a \$10 billion cost reduction to firms that purchase special access—if, indeed, that was the input to the Global Insight macroeconomic model—the result of this policy would be a modest *increase* in costs to firms that purchase telecommunications services as well as to

final consumers. If that cost increase were fed into the Global Insight model, the results would be lower GDP and lower employment rather than the increases trumpeted by AdHoc.

VI. Productivity Growth and X in the Price Cap Formula

53. Sprint Nextel presents an updated study by ETI that purports to measure total factor productivity and the X-factor for interstate special access services.²⁸ In particular, ETI calculates an average historical X-factor of 16.95 percent for interstate special access services between 2000 and 2006. The ETI calculation is methodologically flawed and cannot be relied upon to equalize the growth rates of prices and unit costs for those special access services still remaining under price caps.

A. There is no cat in the room

54. Telecommunications services are supplied by a joint-use network so that the bulk of network costs cannot be meaningfully assigned to the supply of the services that ride that network. In making this observation over 20 years ago, Professor Alfred Kahn noted:

Once you abandon marginal cost, it is not *difficult* to find another measure of cost..., it is hopeless. This is not a question of looking for a black cat in a room where all the lights have been turned out. *There is no cat there.*²⁹

1. Precedent

55. The cat's absence has been noted by this Commission and the DC Circuit Court of Appeals. Indeed, when this Commission considered the issue of an *economic* basis for separating costs and revenues when establishing an X-factor for interstate services, it cast serious doubt on the approach Ad Hoc has recommended some ten years later:

We stated in the LEC Price Cap Performance Review that we would consider making an adjustment to account for differences in interstate and intrastate

²⁸ Exhibit 2 to the Sprint Nextel Comments ("ETI X-factor Update"). Under price regulation, an X-factor is the component of the annual adjustment to the price cap index to account for differences between the expected productivity growths for the telecommunications industry and U.S. industry as a whole. If the X-factor were determined correctly and telecom prices were adjusted every year by inflation minus X, changes in telecom prices would just track changes in telecom unit costs.

²⁹ Alfred E. Kahn, "The Uneasy Marriage of Regulation and Competition," *Telematics*, Vol. 1, 1984, p. 12 (emphasis in the original).

productivity growth if including intrastate data created a “systematic downward bias” in the X factor. We also stated that we would prefer to address any such bias “directly,” rather than by attempting to construct an interstate factor based on regulatory accounting and other regulatory requirements that may not fully reflect economic costs.³⁰

In fact, not only is the use of regulatory accounting data (as Ad Hoc has done) ill-advised, as we explained in previous filings, there is generally no meaningful way to produce separate productivity measures for a firm that produces multiple outputs with a common plant.³¹

56. In its *Brief for Respondents* before the United States Court of Appeals for the District of Columbia Circuit, the Commission acknowledged that interstate productivity is undefined in telecommunications:

One possibility is to calculate an interstate-only measure of productivity growth. To do this, however, the Commission would need to know the changes in quantity of interstate outputs and changes in the quantity of interstate inputs because TFP productivity growth is calculated as the percentage change in the index of outputs minus the percentage change in the index of inputs. While it is relatively straightforward to ascertain the quantity of interstate outputs, it is far more difficult to derive an economically meaningful measure of interstate inputs. This is because a LEC’s inputs are not compartmentalized into those providing interstate services, and those providing intrastate services: the LEC provides both over the same network.³² [Emphasis added].

57. In its decision, the Court agreed with the Commission’s view of the difficulty of an interstate-only TFP stating:

...it is not clear that "interstate productivity," as opposed to total company productivity, is measurable, or even economically well-defined. This is so because direct productivity measurement requires measurement of inputs, and there is no obviously meaningful way to segregate LEC interstate and intrastate inputs because, as is undisputed, "interstate and intrastate services are usually

³⁰ FCC, *In the Matter of Price Cap Performance Review for Local Exchange Carriers and Access Charge Reform End User Common Line Charges*, Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262, released May 21, 1997 (“*Price Cap Order*”) at ¶ 109.

³¹ Taylor Declaration at ¶¶ 66-67.

³² Federal Communications Commission, *Brief for Respondents*, June 15, 1998 at 41 in *United States Court of Appeals for the District of Columbia Circuit, United States Telephone Association, et. al., Petitioners v. Federal Communications Commission and United States of America, Respondents*, No 97-1469. (“*FCC Brief for Respondents*”).

provided over common facilities." 1997 Order, 12 FCC Rcd at 16,685, p 107. The Commission had previously recognized this analytical difficulty, questioning "whether it would be possible to develop separate production functions for interstate and intrastate services," *id.*, and it never unambiguously declared the issue resolved.³³

2. Economic theory

58. The economics literature also recognizes the difficulty in estimating total factor productivity for individual services if there are significant shared and common costs. As discussed by Professors Bernstein and Sappington:

If it were possible to measure the rate of growth of input prices and total factor productivity growth specifically for products that are subject to price-cap regulation, then ... the distinction between regulated services and other services would pose no conceptual difficulties. However, such measurement is generally not possible because of joint products and common factors of production.³⁴ [Emphasis added].

59. In economic theory, TFP growth for subsets of services in a multiproduct firm are *defined* only in very restrictive circumstances—that the production functions for the subsets are separable—and that condition certainly does not hold for telecommunications networks having a large proportion of joint-use facilities. Total factor productivity growth is measured with reference to a production function which specifies the maximum output that can be produced from given quantities of inputs. Using that production function, total factor productivity growth is the difference between the rates of growth of a revenue-weighted index of maximum output quantities and an expenditure-weighted index of input quantities. If there were only two outputs--say interstate and intrastate services--it would not be meaningful to speak of individual TFP growth rates for those services unless the production function can be written in a particular and very restrictive form in which:

- all outputs can be unambiguously separated into intrastate and interstate services;
- all inputs can be unambiguously separated into intrastate and interstate factors of production; and

³³ *United States Court of Appeals for the District of Columbia Circuit, United States Telephone Association, et. al., Petitioners v. Federal Communications Commission and United States of America, Respondents*, No 97-1469.

³⁴ See Jeffrey I. Bernstein and David M. Sappington, "Setting the X Factor in Price-Cap Regulation Plans," *Journal of Regulatory Economics*: 16:5-25 (1999).

- changes in intrastate inputs do not affect interstate output and changes in interstate inputs do not affect intrastate output.

60. Mathematically, these conditions imply that the cost function for the firm can be written as the sum of individual cost functions for interstate and intrastate services.³⁵ But interstate and intrastate telecommunications services are supplied using a high proportion of common facilities, and such technologies are, in fact, not separable in the sense defined above. Interstate and intrastate usage services are produced using the same facilities and expenses. An increase in demand for interstate special access leads to similar changes in investment and expenses as an increase in the demand for intrastate special access or, indeed, for local loops given the common use each make of local distribution plant—*i.e.*, conduit, trenches, poles, etc. In these circumstances, it is impossible to distinguish between the productivity growth rates of intrastate and interstate services. If each additional line of interstate service requires the same increase in inputs as an additional line of intrastate service, then productivity growth in the two sectors will be the same.

61. Note that this result holds irrespective of the output growth rates of the two services. Even if intrastate output is constant, if the identical technology is used to produce intrastate and interstate services, interstate and intrastate services would experience the same growth in total factor productivity, in the sense that the change over time in the amount of output produced per unit of input would be the same. An addition to the rate of growth of interstate output would lead to higher total factor productivity growth for intrastate as well as interstate services.

³⁵ Specifically, the condition that must hold is $C(Q_{\text{inter}}, Q_{\text{intra}}, P_L, P_K, P_M) = C_1(Q_{\text{inter}}, P_L, P_K, P_M) + C_2(Q_{\text{intra}}, P_L, P_K, P_M)$ where P_L , P_K , and P_M are the prices of labor, capital and materials, Q_{inter} and Q_{intra} are quantities of interstate and intrastate outputs and $C_i(Q, P_L, P_K, P_M)$ represents the minimum cost of producing output Q with given factor prices P_L , P_K and P_M . These requirements are known as “separability” restrictions in economic theory, and in particular, they mean that the marginal rate of substitution among interstate factors of production must be independent of the level of intrastate demand (and vice versa). The known presence of economies of scope among interstate and intrastate services means that the cost function cannot be separable, and TFP growth cannot be measured independently for interstate and intrastate services.

62. This inability to define interstate TFP growth is not just a theoretical economic quibble; the fact that productivity growth inures to the entire firm (except under conditions of separability of the production function) is reflected in the prices that emerge from market forces. Prices in competitive markets characterized by common costs are not determined randomly. Rather, as output levels of individual services change, unit costs for the individual services change, and prices will move in predictable ways reflecting costs. One reasonable standard to use in setting a productivity offset is to emulate this movement of prices under competitive conditions. Two examples will help our intuition regarding the relationships among changes in output and technology, productivity growth and changes in unit costs and prices for individual services, showing that changes in interstate output growth can lead to changes in unit costs and prices for intrastate services.
63. First, suppose the regulated firm supplied only two identical services (interstate and intrastate usage) initially at equal volumes and equal prices, using identical facilities which could have both fixed and variable cost components. Suppose that over time, demand for interstate usage doubled while demand for intrastate usage remained constant so that the aggregate quantity of output increased by 50 percent. If aggregate input quantities were assumed to grow at 40 percent, the resulting growth in TFP for the firm would be about 10 percent. Assuming input prices were unchanged, unit costs would fall by about 10 percent.
64. How would this productivity growth be distributed—if it all—between interstate and intrastate usage? First, it should be clear by the symmetry of the assumptions that the change in variable cost is the same for interstate and intrastate usage: an additional minute of each service would increase total costs by exactly the same amount both before and after the change in output. Even though interstate demand growth is assumed to be responsible in this example for the reduction in unit costs, that reduction applies equally to interstate and intrastate services. In this example, it is cheaper to produce an additional unit of intrastate service at higher levels of interstate demand. Thus, if all costs were variable, unit costs for interstate and intrastate services would fall by the same amount (10 percent), and—in unregulated competitive markets—output prices for these services should fall by about the

same amount.³⁶ Second, if all costs were fixed, incremental cost would be zero in each jurisdiction and each additional minute of use would reduce unit costs by the same amount, irrespective of whether the usage were interstate or intrastate. Thus, it is pointless to ascribe faster TFP growth to one service compared with another, when both services share common facilities.

65. A second example in which technological change drives productivity growth may be helpful. Suppose, again, there are only two services—interstate and intrastate usage—of equal size and both services use switches. Suppose asynchronous transfer mode (“ATM”) switches reduce costs, and firms place ATM switches in their networks when it is cost-effective to do so. All else equal, if usage grows more rapidly, ATM switches will diffuse more rapidly throughout the network since where new switch capacity is required, ATM switches would be placed rather than digital switches. The more rapid diffusion of the new technology then leads to an increase in the rate of total factor productivity growth and in the rate at which unit costs for usage falls over time.
66. Now, the rate at which ATM switches are placed in the network depends on the growth in usage but not on the jurisdiction of that usage. For a traffic engineer, the need for additional capacity depends only on peak-period demand, not on whether that demand is interstate or intrastate. As a result, a firm whose interstate demand grew at 10 percent per year while its intrastate demand was constant would experience the same rate of introduction of ATM switches as an otherwise identical firm whose interstate and intrastate growth rates were reversed. Unit costs and—under competitive conditions—market prices for usage would fall more rapidly in both jurisdictions as output in either jurisdiction grows. Thus, growth in interstate usage leads to lower unit costs and lower prices equally for interstate and intrastate usage. The technological change that is assumed to drive productivity growth in this example is induced equally by growth in interstate or intrastate usage, and it reduces costs (and thus prices) for both the slow-growing and fast-growing services identically.

³⁶ This statement is strictly true under the assumption of perfect competition. More generally, reductions in unit costs will result in reductions in prices, but relative price reductions (across services) will depend on demand conditions in each market.

B. Jurisdictional separations do not provide a basis for productivity analysis

67. Outputs can generally be assigned consistently to the interstate or intrastate jurisdictions.

The difficulty for productivity analysis is that the costs associated with producing intrastate and interstate services cannot be separated into corresponding intrastate and interstate components. The Commission's Part 36 Rules do not jurisdictionally separate costs for the purpose of setting prices. They do not reflect cost causation, and interstate costs do not even approximate the economic costs of supplying interstate services. Productivity growth measures based on separated costs would be distorted by changes in the separations formulas and factors and would provide no meaningful information about the productivity growth of interstate services.

68. From the beginning, the separations process was a policy-driven process rather than an attempt to approximate economic costs. Costs allocated to the interstate jurisdiction were recovered from long distance charges while costs allocated to the intrastate jurisdiction could be recovered from intrastate usage charges or from flat-rated monthly charges. Until *Smith v. Illinois Bell* in 1930, none of the costs of local service were assigned to long distance services. The first separations manual was adopted in 1947, and in response to the perceived need to hold down local rate increases, the industry steadily increased the portion of local costs assigned to the interstate jurisdiction.³⁷ By 1982, the presence of competition in interstate long distance markets made increasing subsidies to local service difficult to sustain, and the FCC froze the subscriber plant factor portion of the separations formula, reducing it to a common 25 percent gross allocator in a transition from 1983 to 1986. Following the adoption of price cap regulation for interstate services, the Commission and the Joint Board determined that the industry would be better served by freezing other allocators at their 2000 level pending separations reform that has yet to occur.

³⁷ The percent of non-traffic sensitive (NTS) plant assigned to the interstate jurisdiction was originally set at the interstate minutes of use (SLU) proportion. This proportion increased steadily between 1950 and 1980 from 1.8 times SLU in the Charleston Plan (1952) to 2.5 times SLU in the Denver Plan (1965) to 3.2 times SLU in the FCC Plan (1968), culminating in 3.3 times SLU in the Ozark Plan (1971). For a history of jurisdictional separations, see James W. Sichter, *Separations Procedures in the Telephone Industry: The Historical Origins of a Public Policy*, Program on Information Resources, Harvard University, Cambridge, Massachusetts,

69. Historically, the role of jurisdictional separations was to determine an appropriate amount of local exchange costs to be recovered from long distance revenues. There was and is no pretense that jurisdictionally interstate costs bear any relation to the forward-looking incremental or total costs of supplying interstate services. For example, 25 percent of non-traffic sensitive (NTS) accounting costs are assigned to the interstate jurisdiction even though these costs are not sensitive to the volume of interstate services or even to the presence or absence of interstate services in their entirety.
70. In short, the jurisdictional assignment of costs through Part 36 of the Commission's Rules does not represent an economically meaningful assignment of costs to the categories corresponding to outputs of interstate and intrastate services.³⁸ Changes in separated costs or investment generally have no bearing on corresponding changes in the relative costs of interstate and intrastate services, and using such costs in a TFP study would produce economically meaningless results. As long as interstate and intrastate services are produced using common costs and the same technology, there is no way to identify separate productivity growth rates for interstate and intrastate services.

C. The ETI Update does not measure interstate special access productivity growth

71. Again, because interstate special access productivity growth does not exist, whatever ETI attempts to measure, it is *not* interstate special access productivity growth. Although total factor productivity growth for a single service is not defined, there is a correct method to set

Publication P-77-2, January 1977 or C.L. Weinhaus and A.G. Oettinger, *Behind the Telephone Debates*, Norwood, New Jersey: Ablex Publishing Corporation, 1988

³⁸ The jurisdictional separations process, for all its warts, unambiguously assigns costs between the jurisdictions to determine regulatory responsibility. While the separations process assigns costs on a cost-causal basis to the extent possible, because it must assign all costs, it uses arbitrary but not capricious algorithms to assign shared fixed and common costs on bases unrelated to economic cost. Accounting costs in the aggregate are often used to determine a revenue requirement, but there is no economic basis for using jurisdictionally separated costs for individual services for pricing purposes. When the Commission wishes to estimate the costs (and prices) for individual services that would prevail in competitive markets, it generally begins with forward-looking economic cost concepts. Thus, the Commission reconciles the use of separated costs for some purposes (jurisdictional authority) and economic costs for others (pricing).

X for a single service in a price cap plan, but ETI makes no mention of it. TFP growth for the firm as a whole *is*, of course, well-defined. If we can estimate the growth rates of prices of services outside the price-capped service of interest, the Bernstein-Sappington method correctly takes a TFP measurement for the firm and calculates the value of X for that particular service of interest—say interstate special access—so that the prices of the firm as a whole grow at the same rate as the firm’s aggregate unit costs.

72. ETI does not use this method; rather, it assumes the production process for interstate special access services is separable from that of all other services and purports to calculate an X-factor based on total factor productivity growth for this service. By necessity, this calculation is based entirely on assumption. Output growth is assumed to equal the growth in ARMIS interstate special access lines, which averages approximately 20.9 percent per year over the 2000-2006 period. For input quantities, capital additions and employees are allocated to the special access category in the same proportion as total plant in service is allocated to special access in ARMIS Report 43-01. The quantity of materials is calculated as a residual from an adjustment to ARMIS special access operating expenses. Thus, the growth rates of all three inputs are driven by the growth in total plant in service allocated to special access, and the annual growth of aggregate input quantities in ETI’s calculation averages 0.35 percent. Numerically, ETI’s purported X-factor of 16.95 percent for 2000-2006 is thus dominated by the growth rate of special access lines. All that ETI’s calculation shows, then, is that if special access inputs (assuming they were well-defined) grow at the same rate as the frozen factor that allocates total plant in service to the special access category, the associated X factor is quite large. Such a calculation assumes away the critical economic question as to what investment and costs are increased when special access demand increases. Playing with ARMIS allocations does not even pretend to address the relevant economic question, and the resulting calculated X factor has no use in a price cap formula or as evidence of likely price changes in a competitive market.

VII. Conclusion

73. The events cited in the *Public Notice* have not altered the fundamental economic facts that characterize competition for special access services. Since the *Pricing Flexibility Order* in 1999, customers have benefited from lower prices: the prices actually paid by customers have

fallen throughout Verizon's service territory, falling faster in the aggregate than required by the price cap formula. They have fallen in areas subject to pricing flexibility and in areas still subject to price caps. Prices have continued to fall in the aggregate and for DS-1 and DS-3 services separately.

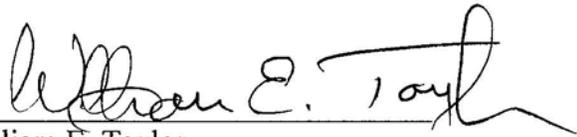
74. Parties raise other economic arguments regarding competition for special access services and its effects, including alleged overearnings, reductions in U.S. GDP and employment, and overpricing based on productivity growth and the X-factor from federal price cap regulation. Each of these claims derives ultimately from the same gross misuse of ARMIS accounts, namely the assumption that ARMIS rates of return for the interstate special access category can be used for setting or assessing prices. Economists have railed against this nonsense for years, and the Commission has explicitly stated that "high or increasing rates of return calculated using regulatory cost assignments for special access services do not in themselves indicate the exercise of monopoly power."³⁹ It follows that calculations that use those regulatory cost assignments will produce economic nonsense, including supposed reductions in welfare or employment from setting prices that earn such returns and estimates of X in the price cap formula based entirely on regulatory cost assignments.

75. At the end of the day, nothing in these data or the calculations that depend on them suggests that the limited pricing flexibility that has been in place since 2001 has resulted in the "substantial and sustained price increases" about which the *Notice of Proposed Rulemaking* inquired.

³⁹ NPRM ¶ 129, citing Franklin M. Fisher & John J. McGowan, "On the Misuse of Accounting Rates of Return to Infer Monopoly Profits," 73 *American Economic Review* (1983). at 83.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct.

Executed on August 15, 2007



William E. Taylor

ATTACHMENT B

**SUPPLEMENTAL REPLY DECLARATION OF
QUINTIN LEW**

REDACTED – FOR PUBLIC INSPECTION

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

In the Matter of)	
)	
Special Access Rates for Price Cap)	WC Docket No. 05-25 &
Local Exchange Carriers)	RM-10593
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SUPPLEMENTAL REPLY DECLARATION OF QUINTIN LEW

1. My name is Quintin Lew. I previously submitted a declaration that was included as Attachment B to Verizon’s Comments filed on August 8, 2007 in this proceeding. *See* Verizon Comments, Attachment B.

2. The purpose of this reply declaration is to rebut claims certain proponents of regulation have made that Verizon’s special access discount pricing plans are anticompetitive. Specifically, I explain below that none of Verizon’s special access discount pricing plans require customers to purchase *all* of the customer’s special access services from Verizon or in any way preclude customers from leasing facilities from alternative providers or self-provisioning. To the contrary, the plans proponents of regulation have complained about the most are the very same plans that many of them have chosen to subscribe to *because* they allow customers to move circuits in and out of service without incurring termination liability, as long as certain minimum service commitments are met. Moreover, I explain that the shortfall structure and fees Verizon assesses when a customer misses its minimum service commitment actually favor the customer

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and are entirely reasonable given the flexibility these plans offer. At the same time, as discussed below, customers do not need to commit large volumes of business to Verizon in order to receive substantial discounts. A customer can achieve savings through a discount plan even if the bulk of its special access demand is served through its own network or if circuits are obtained from an alternative wholesale provider. In addition, customers do not have to subscribe to plans that contain minimum service commitments to obtain substantial discounts on Verizon's special access services. Verizon has special access discount pricing plans that do not require a minimum service commitment that offer the same discounts as those available under plans that do contain minimum service commitments, and many of our customers with smaller volumes choose these plans for this reason. Finally, the termination fee structure and assessments similarly work to the customer's advantage and do not prevent customers from moving circuits from Verizon's network to their own or alternative providers' facilities.

3. Before addressing these points, it is important to understand the role that special access discount pricing plans play in the competitive provision of high-capacity special access services. Term and volume discount plans are offered by all competing providers of high-capacity services for good reason. Term plans promote convenience and ease of administration for both the customer and the provider. A carrier that does not have to expend resources constantly renegotiating terms of service can pass those savings on to their retail customers. Likewise, the costs associated with deploying facilities, marketing, and training support personnel can be recovered over a longer period of time, allowing longer-term rates to be lower

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than shorter-term rates.¹ Similarly, volume discounts provide certainty of demand and reflect economies of scale associated with providing a larger amount of service to a single customer. Term and volume discount plans make it easier for the carrier to plan and budget for the development of its telecommunications network, to tailor services to its precise technical and geographic needs, to spread network design and implementation costs over the period of the contract, and to justify procurement of capital-intensive customer premises and network system equipment. Against this background, I will now address the arguments made in this proceeding by certain proponents of regulation.

I. VERIZON'S SPECIAL ACCESS PRICING PLANS ALLOW CARRIERS TO SELF PROVISION OR LEASE FROM ALTERNATIVE PROVIDERS.

4. As is true of our competitors' offerings, Verizon's special access discount pricing plans offer customers significant discounts off month-to-month rates when they agree to obtain specific special access services from Verizon for a set term or, in some cases, when they combine both volume and term commitments. None of Verizon's special access discount pricing plans preclude carriers from leasing facilities from alternative providers or from deploying the facilities themselves.

¹ In contrast, month-to-month rates are higher because there is a risk that the customer will switch to an alternative provider at any time, making it essential to recover a greater portion of costs in the shortest possible time. For this reason, month-to-month rates in the most competitive areas – such as those where Verizon has received Phase II pricing flexibility – may be higher than in price cap areas (where regulation artificially constrains Verizon's ability to adjust its rates to mirror the structures employed by its competitors). But the significant discounts we are able to offer in these areas with term and now volume discounts more than offset the increases.

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A. Verizon's Commitment Discount Plan Does Not Preclude Carriers From Self-Provisioning or Pursuing Alternatives But Facilitates That Process.

5. A number of proponents of regulation argue that Verizon's discount plans that contain minimum service commitments, such as Verizon's Commitment Discount Plan, "lock up" the customer's special access business by requiring customers to purchase *all* of their special access services with the ILEC and, thereby preventing them from self-provisioning or from leasing facilities from alternative providers. This is not true. The minimum service commitments in Verizon's pricing plans apply only to the special access services the customer purchases with Verizon at the time the customer signs up for the plan; the commitments do not apply to the customer's overall special access volumes.

6. Through our Commitment Discount Plans, Verizon offers discounts on special access services regardless of whether any individual circuit purchased under the plan is kept in service for the term of the plan. Instead, discounts are available as long as the customer maintains a minimum quantity of circuits in service ("minimum service commitment") for the term of years to which the customer subscribes. Under the Commitment Discount Plan, once a one-year minimum service period is met, a customer may move, add, or disconnect circuits during the term of the plan without incurring any circuit-specific termination liability as long as the customer maintains its minimum service commitment. A significant attraction of these plans is that customers need not concern themselves with the status of individual circuits or with being assessed termination liability due to end user churn.

7. Verizon's Commitment Discount Plan was introduced in the Verizon North serving area (the former NYNEX region) in June 1998 and in the Verizon South serving area

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(the former Bell Atlantic region) in June 2004. To participate in Verizon's Commitment Discount Plan, the customer need only have leased from Verizon the equivalent of 14 DS1s. The customer may select from terms of 2, 3, 5, or 7 years and may choose a different term for each category of services – i.e. voice grade, DDS, DS1, or DS3. Although there is a minimum service commitment, the discounts are based solely on the term selected by the customer, not based on the customer's volume.

8. In addition to this circuit portability, the Commitment Discount Plan offers several other significant advantages to customers. Unlike circuit-specific plans, the discounts apply to *all* of the customer's circuits, including those above the minimum commitment level. And it enables the customer to treat all of its circuits as terminating concurrently, rather than keeping track of differing termination dates for each individual DS1 or DS3, as customers must do with Verizon's circuit-specific plans. The latter feature is especially beneficial to Commitment Discount Plan customers because it provides discounts to circuits that are added after the minimum service commitment is established, even though those circuits may be in service for only a few months. For example, if a customer signs up for a 5-year term, the customer may add circuits through the term (at shorter term lengths) and receive the 5-year discount rate for those circuits, yet still have the plan terminate for all of its circuits after the expiration of five years from the initial subscription.

9. In exchange for the added flexibility and other benefits of the Commitment Discount Plan, the customer agrees to maintain a specific quantity of its in-service special access channel terminations with Verizon. Specifically, the customer must maintain a quantity equal to

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90 percent of its initial in-service DS1 and DS3 channel terminations with Verizon for the length of the term selected. The commitment, therefore, applies only to channel terminations. There is no commitment with respect to the customer's transport services.

10. Verizon's Commitment Discount Plans (and other plans containing minimum service commitments) do not require carriers to terminate service with other providers and move that business to Verizon. Nor do Verizon's plans preclude the carrier from self-provisioning. For example, if a carrier has 100 DS1 channel terminations with Verizon and subscribes to a plan with a 90 percent commitment, the customer must keep 90 DS1 channel terminations with Verizon for the term selected. The customer, however, could have hundreds of other circuits it provides itself or obtains from alternative providers. In fact, Verizon rarely knows to what extent carriers are self-provisioning or purchasing from other providers. Verizon's minimum service commitments apply only to what the carrier has agreed to purchase from Verizon. Any growth in special access type services may be given to alternative suppliers or placed on the carriers own network.

11. Contrary to CLECs' claims in this regulatory proceeding, these plans are popular with them and many of them, including **[BEGIN CLEC PROPRIETARY]**

[END CLEC PROPRIETARY] have moved from Verizon's circuit-specific pricing plans to the Commitment Discount Plans because of the flexibility and ease of administration the latter provides.

12. Verizon designed the Commitment Discount Plans to give wholesale customers greater flexibility in managing their special access services than was available under the pre-

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existing circuit-specific terms plans, described below. Although the circuit-specific plans allow for portability and replacement of individual circuits, both Verizon and its wholesale customers found that managing individual circuits can be administratively burdensome, particularly with larger volumes. The Commitment Discount Plans eliminate this problem. In exchange for the minimum service commitment, Verizon allows carriers to move circuits in and out of the Commitment Discount Plans without paying term liability on any individual circuit, after a one year minimum service period, even if the carrier subscribes to the plan for a 5-year term. What this means is that a carrier customer can obtain a 5-year discount rate on an individual circuit, even if it leases the circuit only for 13 months, and will pay no termination liability on that individual circuit if the customer disconnects it before the five-year term is up as long as the carrier still has in service 90 percent of its original in-service volume. Carriers who commit to 3 and 5 year terms under Verizon's Commitment Discount plan can easily move individual circuits to their own network or to alternative provider networks without much risk of paying shortfall penalties. As a result, these plans also give carriers room to negotiate with their retail customers as they do not have to worry so much about fees if their retail customer does not want to commit to a longer term.²

13. Carriers can and do use the flexibility these plans offer to move circuits off of Verizon's network and on to their own network as they build out their facilities or even to move them to alternative providers (or to take advantage of UNEs where available). **[BEGIN CLEC**

² Although XO suggests that Verizon obtains an advantage because it need not require its own retail customers to commit to two year terms, Verizon Business, which manages Verizon's retail sales, leases facilities from the ILEC under the same terms and conditions as Verizon's carrier customers and, therefore, faces the same issues when managing retail customer commitments.

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PROPRIETARY] **[END CLEC PROPRIETARY]**, for example, who purchases services under Verizon's Commitment Discount Plan recently converted approximately 200 special access circuits to UNEs. Similarly, **[BEGIN CLEC PROPRIETARY]** **[END CLEC PROPRIETARY]** which had purchased services under Verizon's Term Volume Plan, a plan in the Verizon West serving area which contains a minimum service commitment, recently informed Verizon that it was moving **[BEGIN CLEC PROPRIETARY]** **[END CLEC PROPRIETARY]** circuits from Verizon to FiberTower.³ Because carriers who participate in Verizon's Commitment Discount Plan (and now Verizon's National Discount Plan) do not have to concern themselves with the status of individuals circuits or with paying termination liability by removing as much as 10 percent of what they lease from Verizon at any given time (and up to 15 percent under National Discount Plan), they can reduce the number of special access services they purchase in one area as they build out their own facilities or pursue alternatives, while using Verizon's special access service in other areas as they begin to develop a customer base in new serving areas. And because the Commitment Discount Plans allow this portability across regions, a carrier could start by leasing 100 channel terminations in New Jersey, build out their facilities there or lease them from a third-party provider, and add channel terminations from Verizon in Maryland, where it is just starting to do business and still receive the benefits of discounts under the plan.

14. Along the same lines, contrary to some CLECs' claims, even under Verizon's Commitment Discount Plans, carriers do not have to commit unreasonably large volumes to

³ See Low Supplemental Declaration ¶ 33.

participate in the plan or to obtain significant discounts. Although the Commitment Discount Plans require carriers to maintain in service with Verizon for the term of years the carrier selects 90 percent of what they lease from Verizon, the discounts are not based on the carrier's volume commitment. The discounts are based on the term selected. A carrier can participate in Verizon's Commitment Discount Plans if it purchases as little as 14 DS1 circuits, and the carrier who subscribes for a 3 year term will receive the same discount on those 14 DS1 circuits as a carrier that leases 14,000 DS1 circuits from Verizon for a 3-year term under the same plan. The minimum service commitment simply requires that the customer maintain at least 90 percent of their initial in-service quantities for the term selected.

15. Furthermore, contrary to some CLEC claims, if a carrier is unable to meet their 90 percent commitment for a given review period, they are not required to pay the full amount through the contract term. The shortfall payment structure in Verizon's Commitment Discount Plans favor the customer and the fees are reasonable. The review period or "true-up" process occurs only every six months. Every six months, Verizon calculates the average number of equivalent DS0 circuits that a customer has in service for the preceding 6-month period. If the average falls below the customer's commitment level, the customer pays a shortfall equal to the average rate per circuit times the number of circuits by which the customer failed to meet the commitment. As a result, even if a carrier falls below the minimum volume commitment during any particular month within that six-month period, there is no shortfall assessment as long as, on average, the carrier met its minimum service commitment. In addition, customers are not required to refund credits they received on all services. Instead the "shortfall" is the difference between what the carrier paid, on average, for the number of circuits they maintained and what

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they would have paid had they met their commitment. So, for example, if a carrier commits to maintain 90 out of 100 of their circuits in service but Verizon determines at their six-month review that they maintained on average only 85, the shortfall assessment is just the average circuit price for the 5 circuits they were short for that period.⁴

16. Plans like Verizon's Commitment Discount Plans, in fact, have been so popular that Verizon recently responded to our carrier customer's requests that we create a similar plan that will provide this type of circuit portability across the Verizon footprint. The National Discount Plan, which Verizon just introduced this year does that. Like the Commitment Discount Plans, it allows customers to place all of their circuits under the plan and drop and add them in any area within Verizon's serving territory without paying termination liability, as long as the carrier maintains their minimum service commitment. Moreover, Verizon responded to carriers' request for the option to have a lower minimum service commitment by providing a two-tiered structure, one that provides substantial discounts for customer that commit to maintain 85 percent of their in-service circuits with Verizon at the time of subscription and a second that provides even greater discounts for customers that choose a 90 percent commitment. In addition, in response to carrier requests, the discounts under the National Discount Plan are based both on the term commitment and on a customer's volume. And contrary to CLEC claims, customers with small volumes can participate in the plan and obtain substantial discounts. The first volume

⁴ The shortfall payment structure and fees are even more lenient in the plans in Verizon's West serving area (former GTE) that contain similar volume commitments. The "true up" process occurs in the West serving area only every 12 months. A customer may miss its commitment by up to 3 percent for DS1s without paying any shortfall assessment, and if the customer misses the commitment by more than 3 percent, the shortfall assessment is only for only 4 months, not the full 12 months.

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tier, for example, offers discounts of more than 30 percent for customers with as few as 1 or as many as 30,000 DS1 equivalent channel terminations.

B. Circuit-Specific Plans Offer Substantial Discounts On Verizon's Special Access Services Without Requiring Any Minimum Service Commitment.

17. Some CLECs also have argued that they can only receive significant discounts off of Verizon's month-to-month special access rates by subscribing to plans that contain minimum service commitments. This also is not true.

18. Verizon offers a variety of plans that provide discounts on Verizon's special access services; plans that contain minimum service commitments, such as Verizon's Commitment Discount Plans, are just one type of these plans. Although several CLECs argue that, to obtain discounts on Verizon's special access services they must subscribe to plans that contain minimum service commitments, many of Verizon's discount pricing plans for special access services do not contain minimum service commitments at all. In addition to the Commitment Discount Plans, which Verizon offers in the Verizon East serving area (former NYNEX and Bell Atlantic regions), Verizon also offers a Term Pricing Plan and a Service Discount Plan. These plans provide increasing discounts when a customer agrees to lease a specific special access circuit from Verizon for a specific term of one to ten years – the longer the term commitment, the greater the discount. The discounts are based on the term selected and generally range from 5 to 40 percent, depending upon the length of term. No minimum service

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commitment is required. Each individual circuit receives a discount based on the service term selected.⁵

19. The discounts under these “circuit-specific” plans are identical to the discounts available under Verizon’s Commitment Discount Plan. A customer that purchases a circuit under one of these plans for a five-year term will receive the same discount as a customer that subscribes to Verizon’s Commitment Discount Plan for a five-year term. The discounts under Verizon’s Service Discount Plan and Term Pricing Plan apply, moreover, even if a customer orders a single circuit. Accordingly, customers do not need to commit large volumes of its special access business with Verizon to receive larger discounts. Even customers with small special access volumes can receive significant discounts on Verizon’s special access services without making minimum service commitments. Indeed, some of Verizon’s carrier customers with smaller special access volumes, such as **[BEGIN CLEC PROPRIETARY]**

[END CLEC PROPRIETARY] purchase under these plans and receive substantial discounts without making any volume commitment at all. And because the circuit-specific plans do not require any minimum service commitment, the discounts apply even if the customer relies primarily on its own network or alternative suppliers.

⁵ Verizon’s circuit-specific plans for DS-1 and DS-3 circuits are available throughout the territory of a single tariff filing entity, and very similar plans are offered by each of the entities. In the former Bell Atlantic serving area, for example, the plan labeled Term Pricing Plan, provides discounts on DS-1 channel terminations ranging from 15 to 40 percent for terms of 2, 3, 5, and 7 years. In the former NYNEX region, the plan known as the Service Discount Plan offers discounts on DS-1 channel terminations ranging from 15 to 40 percent for individual circuits for terms of 2, 3, 4, 5, or 7 years. And both plans offer similar discounts on channel mileage.

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C. Termination Provisions In Verizon's Tariffs Are Fair and Reasonable And Do Not Prevent Customers From Moving Off Verizon's Network.

20. Although CLECs complain about termination liability in Verizon's discount plans, imposing termination liability when a customer discontinues service under a term plan prior to its expiration is a legitimate means of assuring that a service provider recovers the costs incurred in initiating and continuing to provide service to customers that receive discounts in exchange for term commitments. Termination liabilities enable carriers to recover facility costs and up-front sunk costs involved in provisioning circuits to a special access customer. Similarly, when a customer agrees to a term commitment in exchange for a greater discount, termination liability assures that the service provider gets the benefit of the bargain if the customer terminates prior to expiration of the agreement. Termination liability, therefore, makes it possible for Verizon to offer substantial discounts to its customers. Without term liabilities, carriers would have to seek more onerous obligations, such as substantial up-front payments, or discontinue term discounts altogether.

21. Contrary to CLEC claims, the termination provisions in Verizon's tariffs, both circuit-specific and non-circuit specific, are fair and reasonable and do not prevent carrier customers from moving services off of Verizon's network on to their own or an alternative providers' facilities. If a circuit-specific plan is terminated prior to expiration of the term commitment, the customer generally is no worse off than the customer would have been had the customer signed up for the term equivalent to the time the circuit actually was in service with Verizon. For DS1s and DS3s in Verizon's East serving area, for example, the customer pays the lesser of (1) a specific percentage (15 or 50 percent, depending on the plan), of the monthly rate

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for the unexpired portion of the term; or (2) the difference between the rates for the term the customer subscribed to and the rates for the term the customer could have satisfied.⁶

Accordingly, because Verizon's discount plans come in a variety of terms, ranging from 1 to 10 years, carriers that wish to move their special access circuits to another provider or to their own facilities in the short term can opt for shorter-term plans and still receive significant discounts off Verizon's month-to-month rates.

22. For Verizon's non-circuit specific plans, such as the Commitment Discount Plan, termination liability applies *only* if the plan is terminated in its entirety. That is, customers are free to terminate individual circuits as long as they maintain the minimum volume commitment described above. If a customer does terminate a non-circuit specific plan in its entirety, the customer generally will receive the discounts to which it was entitled; termination liability is calculated in the same manner as described for Verizon's circuit specific plans.

23. This concludes my declaration.

⁶ In the Verizon West serving area, the customer pays a specific percentage of the monthly rate, which declines in later years of the plan term. For example, several plans have a 45-percent termination liability in the first year, declining to 30 percent in the second year, 25 percent in the third year, and 20 percent in the fourth and any subsequent years.

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I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct.

Executed on August 15, 2007



Quintin Lew

ATTACHMENT C

REPLY DECLARATION OF PATRICK A. GARZILLO

**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 & RM-10593

REPLY DECLARATION OF PATRICK A. GARZILLO

1. My name is Patrick A. Garzillo. I previously submitted a declaration that was included in Attachment E to Verizon's Comments filed on August 8, 2007. The purpose of this reply declaration is to describe additional data Verizon is submitting demonstrating that, in addition to the general decline in average prices customers are paying for special access services, certain carrier customers also experienced significant declines in the prices they pay for Verizon's DS1 and DS3 special access services in the period since the Commission adopted pricing flexibility.

A Customer-Specific Average Revenue per Unit

2. In addition to the data Verizon collected to calculate company-wide average revenue per unit for special access services, Verizon also collected data to calculate the average revenue per unit that specific Verizon carrier customers are paying for DS1 and DS3 special access services. Verizon's data show that, on average, the prices these customers are paying for special access services have been declining.

3. Verizon calculated its average revenue per unit ("ARPU") for the specific customers individually for DS1 and DS3 services, for 2002 and 2006. Verizon also

separately determined the ARPU for the channel termination and channel mileage portions of these services.

4. First, Verizon determined revenue and volumes for these customers for DS1 and DS3 services, separately for channel terminations and channel mileage, and separately for the Verizon East serving area (the former NYNEX and Bell Atlantic regions) and the Verizon West serving area (the former GTE regions). Data were available for 2002 and 2006 for both Verizon East and Verizon West serving areas. Data is not available for Verizon West prior to 2002.

5. Second, average channel termination revenue per channel termination and average channel mileage revenue per channel mileage were calculated separately for the Verizon East and Verizon West serving areas and for total Verizon for these customers. To calculate DS1 and DS3 circuit ARPUs, Verizon multiplied the average channel mileage ARPU by the average miles per channel termination and added the result to the channel termination ARPU. For 2006, the 2002 average channel mileage per channel termination was utilized. The 2002 average channel mileage per channel termination was calculated separately for DS1s and DS3s, and separately for the Verizon East and Verizon West territories and total Verizon. This calculation prices, for the two years, a circuit containing one channel termination and a fixed amount of channel mileage (based on the average mileage in 2002). All ARPUs were calculated in real terms (adjusted for inflation). The total percent change and the annual percent change in total DS1 and DS3 ARPUs for these specific customers are shown in Exhibit 1 attached hereto.

6. This concludes my declaration.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct.

Executed on August 15, 2007


Patrick A. Garzillo

REPLY DECLARATION OF PATRICK A. GARZILLO

EXHIBIT 1

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