Special Access Pricing

Sprint Nextel Corporation

Written *Ex Parte* Presentation
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SPRINT NEXTEL WRITTEN *EX PARTE* ON SPECIAL ACCESS PRICING

I. BACKGROUND

The Commission commenced this proceeding in 2005 to undertake a broad examination of the regulatory framework that should apply to the provision of interstate special access services[1] by price cap incumbent local exchange carriers ("LECs") after expiration of the Coalition for Affordable Local and Long Distance Services ("CALLS") Plan on June 30, 2005.[2] In doing so, it expressly noted that the assessment of special access regulation was warranted, in part, because of the "increased importance of special access services relative to other access services."[3] In addition, the Commission has an overarching obligation to ensure that charges and practices for and in connection with interstate communications – including special access – are just and reasonable.[4] The

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1 The Commission has defined special access as a dedicated transmission link between two locations. *See, e.g., AT&T Inc. and BellSouth Corporation, Application for Transfer of Control*, Memorandum Opinion and Order, 22 FCC Rcd 5662, ¶ 27 n.88 (2007) ("*AT&T/BellSouth Merger Order*"). Under this definition, "special access" includes any dedicated transmission link, regardless of the type of technology deployed over that link (including Ethernet and other packet-based services). *See id.* (using the term "special access" to include *all* services that involve dedicated transmission links). Throughout this document, the discussion of special access is limited to interstate special access.

2 *Special Access Rates for Price Cap Local Exchange Carriers; AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, Order and Notice of Proposed Rulemaking, 20 FCC Rcd 1994, ¶ 2 (2005) ("*2005 Special Access NPRM*" or "*NPRM*").

3 *Id.* ¶ 3.

4 47 U.S.C. § 201(b).

2005 Special Access NPRM and the ensuing 2007 *Public Notice*[5] are just the latest steps in the Commission's ongoing examination and regulation of special access rates.

Until the end of 1990, interstate access charges assessed by all incumbent LECs were governed by "rate-of-return" or cost-of-service rules.[6] Under cost-of-service rules, an incumbent LEC's interstate access rates were calculated by projecting costs and demand for access services. An incumbent LEC was permitted to recover its costs plus a prescribed return on investment.[7] Rate of return regulation, however, was criticized because it created incentives for carriers to operate inefficiently[8] and did not reward carriers that improved their efficiency,[9] making it particularly ill-suited for an industry subject to growing competition and technological development.[10]

In late 1990, the Commission replaced its rate-of-return rules with new price cap regulations that applied to the largest LECs.[11] The new regulations were intended to create incentives for price cap LECs to reduce their costs and increase their productivity. Rather than adjusting prices to target a prescribed return on investment, price cap regulation controls the prices that an incumbent LEC may charge while allowing its

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5 Public Notice, "Parties Asked to Refresh Record in the *Special Access Notice of Proposed Rulemaking*," 22 FCC Rcd 13352 (2007) (FCC 07-123) ("*Public Notice*").

6 *See Access Charge Reform*, Fifth Report and Order and Further Notice of Proposed Rulemaking, 14 FCC Rcd 14221, ¶ 11 (1999), *aff'd sub nom. WorldCom v. FCC*, 238 F.3d 449 (D.C. Cir. 2001) ("*1999 Pricing Flexibility Order*").

7 If the incumbent LEC's return exceeded the authorized rate, it could be required to refund the excess to access customers that filed complaints at the FCC.

8 *Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, 5 FCC Rcd 6786, ¶ 29 (1990) ("*1990 LEC Price Cap Order*").

9 *Id.* ¶ 22.

10 *See id.* ¶¶ 27-28.

11 *Id.* Price cap regulation was mandatory for the BOCs and GTE and optional for other incumbent LECs. *Id.* ¶¶ 6, 260-262.

earnings to vary.[12] The initial access charge rates under price caps were set based on the most recent rates adopted under the cost of service rules.[13] The Commission acknowledged that establishing the initial Price Cap Index ("PCI") on the basis of historical rates established under a rate-of-return system was imperfect.[14] It explained, however, that the July 1, 1990 rates were the best that rate-of-return regulation could produce at the time and that the PCI would "ensure[] that any inefficiencies embodied in current rate of return rates [would be] eliminated over time, as the LECs are able to improve their productivity."[15]

Under the FCC's traditional price cap regime, PCIs, which determine the maximum rates that price cap LECs are permitted to charge, are adjusted annually by a measure of inflation minus an X-factor. The X-factor represents an estimate of the amount by which incumbent LECs' productivity growth rate is expected to exceed the productivity growth rate of the economy as a whole.[16] Other adjustments can be made to the PCIs for exogenous costs.[17]

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12 *Id.* ¶ 47 ("By employing a regulatory system that shifts our focus to prices while permitting retention of some reasonably higher earnings, we provide carriers an incentive to become more productive, and to offer new services. To provide a quantitatively achievable incentive for the LECs, the price cap mechanism includes components that reflect historical LEC productivity, and then requires them to out-perform historical trends.").

13 *Id.* ¶ 230.

14 *Id.* ¶¶ 232-233.

15 *Id.* ¶ 242.

16 *Id.* ¶ 48. The X-factor is a mechanism "aimed at capturing a portion of expected increases in carrier productivity, so that these improvements, as under competition, will result in lower prices for consumers." *United States Tel. Ass'n v. FCC*, 188 F.3d 521, 524 (D.C. Cir. 1999) ("*USTA v. FCC*").

17 Exogenous costs are those costs that are triggered by administrative, legislative or judicial action beyond the control of the carriers. *1990 LEC Price Cap Order* ¶¶ 48, 167.

After enactment of the Telecommunications Act of 1996, the Commission further revised its interstate access charge rules to accommodate its expectation that sufficient competition would develop to move access charges toward economically efficient levels and permit the progressive deregulation of incumbent LECs.[18] As part of these reforms, the Commission in 1997 amended its price cap rules to prescribe an X-factor of 6.5 percent annually[19] and to eliminate the sharing requirement,[20] concluding that "sharing severely blunts the efficiency incentives of price cap regulation by reducing the rewards of LEC efforts and decisions."[21] In a companion decision adopting changes to its access charge rules, the Commission expressed confidence that:

> the pro-competitive regime created by the Act and implemented in the Local Competition Order and numerous state decisions will generate workable competition over the next several years in many cases, and we would then expect . . . access price levels to be driven to competitive levels. We also recognize, however, that competition may develop at different rates in different places and that some services may prove resistant to competition. Where competition has not emerged, we reserve the right to adjust rates in the future to bring them into line with forward-looking costs. To assist us in that effort, we will require price cap LECs to

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18 *Price Cap Performance Review for Local Exchange Carriers; Access Charge Reform*, Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262, 12 FCC Rcd 16642, ¶14 (1997) ("The rules we adopt in this Order are an essential part of access reform. They are necessary to promote, and plan for, the growth of competition envisioned by the Telecommunications Act of 1996.") ("*1997 Price Cap Review Order*").

19 *Id.* ¶ 141. The Court of Appeals for the D.C. Circuit reversed and remanded the Commission's decisions to select 6.0 percent as the first component of the X-Factor and to retain the 0.5 percent Consumer Productivity Dividend. *USTA v. FCC*, 188 F.3d at 531.

20 At one point, price cap LECs were subject to "sharing" obligations, which required incumbent LECs to "share" half or all their earnings above specified rates of return with their access customers through lower PCIs during the following year. *See 1997 Price Cap Review Order* ¶ 10.

21 *Id.* ¶ 148.

> submit forward-looking cost studies of their services no later than February 8, 2001, and sooner if we determine that competition is not developing sufficiently for the market-based approach to work.[22]

The Commission indicated its intention to review competitive conditions in the access marketplace and the forward-looking cost studies at a later time.

Subsequently, in the *CALLS Order*,[23] the Commission adopted a five-year plan to phase out implicit subsidies in access charges and to move toward a market-based approach for determining interstate access rates. It provided carriers with a choice of either electing the CALLS plan or completing the forward-looking cost studies required by the *1997 Access Charge Reform Order*.[24] All price cap carriers opted for the CALLS plan.[25] One aspect of the CALLS plan required price cap LECs to separate special access services into their own "basket" and apply a separate X-factor to that basket.[26] Once again, the FCC expressed the hope that competition would develop sufficiently during the five-year CALLS period to permit deregulation of access charges for price cap LECs.

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22 *Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Transport Rate Structure and Pricing; End User Common Line Charges*, First Report and Order, 12 FCC Rcd 15982, ¶ 48 (1997) ("*1997 Access Charge Reform Order*"), *aff'd sub nom. Southwestern Bell Tel. Co. v. FCC*, 153 F.3d 523 (8th Cir. 1998).

23 *Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Low-Volume Long Distance Users; Federal-State Joint Board on Universal Service*, Sixth Report and Order in CC Docket Nos. 96-262 and 94-1; Report and Order in CC Docket No. 99-249, Eleventh Report and Order in CC Docket No. 96-45, 15 FCC Rcd 12962 (2000) ("*CALLS Order*").

24 *Id.* ¶ 57.

25 *See Petition for Forbearance of Iowa Telecommunications Services, Inc. d/b/a Iowa Telecom Pursuant to 47 U.S.C. § 160(c) from the Deadline for Price Cap Carriers to Elect Interstate Access Rates Based on the CALLS Order or a Forward Looking Cost Study*, Order, 17 FCC Rcd 24319, ¶ 3 (2002).

26 *CALLS Order* ¶ 172.

> [W]e believe that increased competition will serve to constrain access rates in the later years of the CALLS Proposal as X-factor reductions are phased out. We believe that market forces, instead of regulatory prescription, should be used to constrain prices wherever possible. As competitors utilizing a range of technologies, including cable, cellular, MMDS and LMDS, continue to enter the local exchange market, we expect that rates will continue to decrease. We also believe that adoption of the CALLS Proposal will encourage competition by removing implicit subsidies in access charges and recovering costs from those services that cause them. Therefore, the significant up-front reductions coupled with increased competition ultimately should result in access charges that are comparable to those that would be achieved under our current price cap system over the five-year term of the CALLS Proposal. Furthermore, after the five-year term we can re-examine the issue to determine whether competition has emerged to constrain rates effectively.[27]

In a separate proceeding, the Commission revised its rules to give price cap LECs greater pricing flexibility if competition for special access services emerged. Specifically, the Commission adopted a two-phase pricing flexibility framework that was "designed to grant greater flexibility to price cap LECs as competition develops, while ensuring that: (1) price cap LECs do not use pricing flexibility to deter efficient entry or engage in exclusionary pricing behavior; and (2) price cap LECs do not increase rates to unreasonable levels for customers that lack competitive alternatives."[28] As part of the flexibility framework, the Commission designed competitive triggers intended to measure the extent to which competitors had established "a significant market presence, *i.e.*, that

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[27] *Id.* ¶ 166 (footnotes omitted); *see also id.* ¶ 36 ("The CALLS Proposal . . . is a transitional plan that moves the marketplace closer to economically rational competition, and it will enable us, once such competition develops, to adjust our rules in light of relevant market developments. Consequently, as the term of the CALLS Proposal nears its end, we envision that the Commission will conduct a proceeding to determine whether and to what degree it can deregulate price cap LECs to reflect the existence of competition.").

[28] *1999 Pricing Flexibility Order* ¶ 3.

competition for a particular service within the MSA is sufficient to preclude the incumbent from exploiting any monopoly power over a sustained period."[29]

The Commission measured the potential for competition to incumbent LEC special access services by analyzing the extent to which competing providers had made irreversible, sunk investments in collocation and transport facilities. The FCC adopted separate triggers for channel terminations and for other special access services. For each category of service, the FCC adopted triggers for Phase I pricing flexibility and more rigorous triggers for Phase II pricing flexibility. Phase I pricing flexibility allows price cap LECs to offer contract tariffs and volume and term discounts for those services for which they make a specific competitive showing (although under Phase I, the price cap LECs must maintain their generally available, price cap-constrained tariffed rates for these services). Phase II pricing flexibility allows LECs to offer special access service at unregulated rates through generally available tariffs and contract tariffs.

AT&T Corp. filed a Petition for Rulemaking on October 15, 2002 that essentially asked the Commission to repeal its Phase II pricing flexibility rules.[30] AT&T's Petition contended that the Phase II pricing flexibility triggers were flawed, because they did not accurately indicate the presence of competing providers in a particular geographic area. Consequently, price cap LECs were able to obtain Phase II flexibility in areas where they

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[29] *Id.* ¶ 141. The Commission explained that "[b]y significant market presence, we mean that . . . *almost all special access customers have a competitive alternative.*" *Id.* ¶ 142 (emphasis supplied); *see also id.* ¶ 147 (describing the Phase II triggers as access customers having "competitive alternatives throughout *most of an MSA.*") (emphasis supplied).

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

did not face meaningful competition to their special access services.[31] AT&T also asked the Commission to grant interim relief by suspending the pricing flexibility rules and reducing the rates for all special access charges subject to Phase II pricing flexibility to levels that would allow an 11.25 percent rate of return.[32] Price cap LECs generally opposed AT&T's Petition, claiming that there was robust competition in the provision of special access services and that their rates for those services were reasonable.[33]

A few months before the five-year term of the CALLS plan was scheduled to expire, the Commission issued a Notice of Proposed Rulemaking in this proceeding to undertake a comprehensive examination of the appropriate regulatory framework that should govern price cap LECs' special access services post-CALLS.[34] The Commission sought comment on whether the BOCs' increasing average special access rates of return indicated a need for an X-factor that is higher than the one employed under the CALLS plan,[35] whether to maintain an X-factor unique to special access services,[36] and whether to reinitialize rates to ensure they are just and reasonable.[37] The *2005 Special Access NPRM* also sought comment on whether the Commission's pricing flexibility rules had worked as intended and, if not, whether (and how) they should be modified (or

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31 *Id.* at 11-13, 25-32.

32 *Id.* at 39-40.

33 *See* Opposition of SBC Communications Inc., RM-10593, at 10-13; 22-24 (Dec. 2, 2002); Opposition of Verizon, RM-10593, at 9-14 (Dec. 2, 2002).

34 *2005 Special Access NPRM.*

35 *Id.* ¶ 35.

36 *Id.* ¶ 37.

37 *Id.* ¶ 59.

repealed).[38] For example, it sought comment on, *inter alia*, the state of competition in the marketplace, including whether there had been substantial and sustained special access price increases in Metropolitan Statistical Areas ("MSAs") in which the LEC had been granted Phase II pricing flexibility;[39] whether actual marketplace developments had validated the predictive judgments the Commission had made in the *1999 Pricing Flexibility Order* regarding supply responsiveness and entry barriers;[40] and whether changes should be made to the definitions of the relevant product and geographic markets.[41] The Commission also asked whether it should apply a 5.3 percent X-factor to special access price cap rates as an interim measure while it considered what regulatory regime would follow the CALLS plan.[42]

Since the release of the *2005 Special Access NPRM*, the Commission has approved several significant telecommunications mergers. In the cases of Verizon/MCI and SBC/AT&T, the Commission determined that the mergers, as conditioned by Department of Justice ("DoJ") Consent Decrees, would not result in anticompetitive effects in the markets for special access services.[43] Similarly, the Commission concluded that the AT&T/BellSouth merger, in conjunction with the merged company's divestiture commitment, would not result in anticompetitive effects in the market for special access

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38 *Id.* ¶ 71.

39 *Id.* ¶ 74.

40 *Id.* ¶ 80.

41 *Id.* ¶¶ 82, 87.

42 *Id.* ¶ 131.

43 *Verizon Communications Inc. and MCI, Inc. Applications for Approval of Transfer of Control*, Memorandum Opinion and Order, 20 FCC Rcd 18433, ¶ 55 (2005) ("*Verizon/MCI Merger Order*"); *SBC Communications Inc. and AT&T Corp. Applications for Transfer of Control*, Memorandum Opinion and Order, 20 FCC Rcd 18290, ¶ 55 (2005) ("*SBC/AT&T Merger Order*").

services.[44] However, in its decisions in all three proceedings, the Commission indicated that concerns about the extent of incumbent LECs' abilities and incentives to discriminate against competitors using special access inputs were more appropriately addressed in this proceeding.[45] Moreover, the FCC recognized in its recent order on program access that horizontal consolidation in an industry increases the incentive and ability of companies to deny inputs to their competitors.[46]

In November 2006, in response to a request from Congress, the U.S. Government Accountability Office ("GAO") issued a report on the status of competition in the provision of special access services.[47] The GAO Report found that facilities-based competition in special access services was lacking. The GAO reported that its survey of 16 major metropolitan areas showed that facilities-based competitors were serving, on average, less than 6 percent of the buildings with at least a DS1 level of demand.[48]

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44 *AT&T/BellSouth Merger Order* ¶¶ 49, 57, 60.

45 *Verizon/MCI Merger Order* ¶ 55; *SBC/AT&T Merger Order* ¶ 55; *AT&T/BellSouth Merger Order* ¶ 60.

46 *Implementation of the Cable Television Consumer Protection and Competition Act of 1992; Development of Competition and Diversity in Video Programming Distribution: Section 628(c)(5) of the Communications Act; Sunset of Exclusive Contract Prohibition; Review of the Commission's Program Access Rules and Examination of Programming Tying Arrangements*, MB Docket Nos. 07-29 and 07-198, Report and Order and Notice of Proposed Rulemaking, FCC 07-169, ¶ 54 (rel. Oct. 1, 2007) ("Now that the market share of the four largest vertically integrated MSOs has increased to between 54 and 56.75 percent, the largest vertically integrated cable operators stand to gain even more from a withholding strategy. Thus, the increase in horizontal consolidation in the cable industry since 2002 increases the incentive to pursue anticompetitive withholding strategies.").

47 United States Government Accountability Office ("GAO"), Report to the Chairman, Committee on Government Reform, House of Representatives, *Telecommunications: FCC Needs to Improve its Ability to Monitor and Determine the Extent of Competition in Dedicated Access Services* (Nov. 30, 2006), *available at*: <http://www.gao.gov/new.items/d0780.pdf> ("GAO Report").

48 *Id.* at 12.

GAO's data also showed that "phase II areas generally have a lower percentage of lit buildings than phase I areas, indicating that the FCC's competitive triggers may not accurately predict competition at the building level."[49]

With respect to special access prices, the GAO Report found that since Phase II pricing flexibility was first granted, list prices for dedicated access provided pursuant to Phase II pricing flexibility had increased, on average. By contrast, list prices available in Phase I and price cap areas decreased over the same period largely due, in GAO's estimation, to the *CALLS Order*, which included a special access-specific X-factor for the first three years of the plan.[50] The GAO Report also concluded that prices for dedicated access services in MSAs with Phase II pricing flexibility were, on average, higher than in Phase I or price cap MSAs.[51]

The GAO Report ultimately concluded that the Commission's data had "significant limitations in [its] ability to describe the presence, extent, or change in competition."[52] It faulted the FCC's data as not being current and indicated that once the Commission granted pricing flexibility in a particular area, it did not thereafter review the state of competition for special access services in that area.[53] The Report explained that

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49 *Id.* at 12-13.

50 *Id.* at 13.

51 *Id.* at 13, 27. Although the Commission anticipated price increases in some areas, the GAO's analysis "showed that prices increased on average, regardless of density zone or any other parameters – although prices did increase more on average in lower density areas than higher density zones, and increased more for shorter term lengths than longer term lengths." *Id.* at 28.

52 *Id.* at 36.

53 *Id.* at 39. The Report states that "the data presented in a price flexibility petition measure potential competition at one point in time and [the] FCC does not revisit or update them, even though competitors may enter bankruptcy or be bought by another firm." *Id.* at 14-15.

the FCC's data on special access competition often are not specific enough to be useful, and have limited reliability (given that the information typically is provided by outside parties with economic interests in a particular outcome).[54] The GAO Report noted the "need for better data at [the] FCC to track competition and deployment of telecommunications services to a variety of consumers,"[55] and observed that without more complete and reliable data, the Commission would be unable to determine whether its deregulatory policies were achieving their goals.[56]

In light of several significant industry mergers, the issuance of the GAO Report on special access services and other industry developments, the Commission invited interested parties to update the record in this rulemaking proceeding.[57] Specifically, the Commission asked parties to comment on, *inter alia*, the effect of recent mergers on the availability of competitive special access facilities and providers, how special access pricing affects the price and availability of wireless services, whether technological changes warrant a change in the relevant product market, and whether changes in the market for special access services have affected the availability of competitive alternatives.[58]

II. THE MARKETPLACE FOR PRICE CAP SPECIAL ACCESS SERVICES

The threshold issue in fashioning a regulatory regime to govern price cap special access services in the post-CALLS period "is to determine the type of rate regulation, if

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54 *Id.* at 39-40.

55 *Id.* at 43.

56 *Id.* at 36-37, 43.

57 *Public Notice*.

58 *Public Notice* at 2-3.

any, that should apply."[59] The parties commenting in this proceeding present strikingly different descriptions of today's special access marketplace. The price cap LECs contend that competition in the provision of special access is robust and widespread and, therefore, greater relaxation of existing pricing controls is warranted. Special access customers, in contrast, assert that alternatives to price cap LEC special access offerings are limited in both the array of services offered as well as the geographic areas in which they are available. They, along with other commenters, urge the Commission to adopt additional regulatory controls over the special access services that are subject to pricing indices.[60] Before examining those competing claims more closely, it is useful to analyze whether the price cap LECs have continued to realize economies of scale in the provision of special access. If so, that would suggest that they continue to enjoy a competitive advantage that other providers with far less extensive networks cannot currently match.

A. Economies of Scale and Scope

In the *2005 Special Access NPRM,* the Commission observed that "[s]pecial access services have significant economies of scale and scope."[61] Specifically, the bulk of the costs incurred to deploy a special access line are incurred in obtaining rights-of-way and access to buildings and in digging trenches or accessing poles or other conduits. Those costs substantially exceed the cost of the fiber strand or copper wire used to

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59 *NPRM* ¶ 24.

60 Special access customers also claim that the rules under which incumbent LECs have obtained pricing flexibility, especially Phase II flexibility, are flawed and should be repealed. Because services subject to Phase II flexibility are removed from price caps, those issues are discussed in a subsequent section.

61 *NPRM* ¶ 26.

physically connect locations on a carrier's network.[62] Further, price cap LECs can "increase the capacity on many special access routes at a relatively low incremental cost . . . by adding or upgrading terminating electronics."[63]

The effects of these economies of scale and scope are reflected in the record in this proceeding. For example, the Commission's examination of Automated Reporting Management Information System (ARMIS) data in 2005 showed that "special access line demand increased at a significantly higher rate than did operating expenses and investment" both before and after the CALLS plan and pricing flexibility rules were implemented.[64] In other words, the data indicated that the "BOCs have realized special access scale economies throughout the entire period of price cap regulation."[65]

A review of ARMIS data for more recent periods indicates that these same trends have continued. For example, the following table contains updated data for the period 2000-2006 for the BOCs.

Special Access Compound Annual Growth Rate 2000-2006					
	Digital Lines	Operating Revenue	Operating Expense	Avg. Net Investment	Rate of Return
BOC Total	21.2%	8.4%	3.0%	-5.2%	18.8%

Consistent with the Commission's previous findings, this updated information shows that during the period the FCC's pricing flexibility rules have been in effect, the BOCs' operating revenue and number of lines grew at a much faster rate than their

62 *Id., citing AT&T Petition for Rulemaking* at 29.

63 *Id.*.

64 *NPRM* ¶ 29.

65 *Id.*

expenses and investment. Moreover, the pace of BOCs' efficiency gains has increased in the period since the Commission released the *NPRM* in 2005:

Special Access Compound Annual Growth Rate 2004-2006					
	Digital Lines	Operating Revenue	Operating Expense	Avg Net Investment	Rate of Return
BOC Total	34.5%	8.0%	-1.8%	-14.1%	34.8%

These updated data show that the BOCs are continuing to generate significant special access revenue and line growth while *decreasing* both expense and investment. In addition, the compound annual growth in the ARMIS rates of return for the BOCs has increased at a faster pace in 2004-2006 than in the 2001-2003 period. The Commission calculated a compound annual growth rate in BOC rates of return of 17 percent for the 2001 to 2003 period.[66] The compound annual growth rate in the BOCs' rates of return from 2004 to 2006 was nearly 35 percent.[67]

The price cap LECs have criticized the use of ARMIS data, particularly data generated after the Commission froze certain cost allocation factors. They contend that the data reported in ARMIS do not serve a ratemaking purpose.[68] The price cap LECs

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66 *NPRM* ¶ 27.

67 These double digit growth rates have culminated in the BOCs' achieving rates of return as high as triple digits. For example, AT&T's rate of return for 2006 was approximately 100 percent. *See, e.g.*, Comments of Sprint Nextel Corporation at 8 (Aug. 8, 2007) ("Sprint Nextel Comments"); Declaration of Susan M. Gately at 7, Figure 3.1 ("Gately Decl."), attached as Appendix 2 to the Comments of the Ad Hoc Telecommunications Users Committee (Aug. 8, 2007) ("Ad Hoc Comments"); *see also* FCC ARMIS Report 43-01, Table 1 – Cost and Revenue, Column (s) (Special Access), Row 1915 (Net Return) divided by Row 1910 (Average Net Investment). (Unless otherwise indicated, all comments cited herein were filed in WC Docket No. 05-25.)

68 *See* Supplemental Reply Comments of AT&T Inc. (Redacted Version) at 47-48 (Aug. 15, 2007) ("AT&T Reply Comments"); Comments of Verizon (Redacted Version) at 43 (Aug. 8, 2007) ("Verizon Comments").

further argue that the ARMIS accounting categories do not track economic costs, but instead are driven by regulatory considerations, such as jurisdictional separations and divisions between regulated and unregulated services.[69] Finally, the price cap LECs claim that the separations freeze established in June 2001 further distorts the ARMIS data.[70] As a result, they assert that it would be erroneous to use ARMIS data to calculate the rates of return for price cap LECs.[71]

The foregoing analysis, however, uses "ARMIS data for the limited purpose of examining the relationship between demand growth and growth in expenses and investment."[72] As the Commission has observed previously, "[t]o the extent the accounting rules have remained the same over the period analyzed, the analysis of growth rates and scale economies should not be significantly affected by the cost allocation issues" raised by the price cap LECs.[73] Therefore, the data are useful in evaluating the ability of incumbent LECs to realize increasing economies of scale in the provision of special access over time.

The price cap LECs' objections are further undermined by the fact that they had the opportunity to submit information to correct the asserted distortions in the ARMIS data, but declined to do so. For example, the *2005 Special Access NPRM* specifically invited parties to revise the ARMIS data by removing non-directly assignable interstate special access investment and expenses and calculating the compound annual growth

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69 Verizon Comments at 43; Comments of Qwest Communications International Inc. (Redacted Version) at 50-51 (Aug. 8, 2007) ("Qwest Comments").

70 Qwest Comments at 51-52; Verizon Comments at 44.

71 *See, e.g.,* AT&T Reply Comments at 36; Verizon Comments at 43.

72 *NPRM* ¶ 29.

73 *Id.*

rates for interstate special access operating expenses and average investment using the revised inputs.[74] No commenter submitted such revised information into the record of this proceeding.

Some price cap LECs have argued that the Commission should not address special access without also considering interstate switched access rates.[75] The Commission is currently considering appropriate switched access rates as part of its ongoing intercarrier compensation proceeding.[76] Accordingly, the Commission need not address claims regarding switched access rates in this proceeding.

In sum, the Commission noted in the *2005 Special Access NPRM* that ARMIS data suggest the BOCs have realized special access scale economies throughout the entire period of price cap regulation.[77] Data from the period since the *NPRM* was released indicate that that trend has continued. Under the CALLS plan, however, the price cap LECs, beginning in 2004, were not required to share any of their productivity gains with their special access customers, even in areas subject to price caps. The decision not to require price cap LECs to adjust their rates to reflect productivity gains was based, at least in part, on an expectation that competition would emerge to replace regulation as a constraint on special access prices and that the FCC would be able to deregulate special

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74 *NPRM* ¶ 29.

75 *See, e.g.*, Qwest Comments at 52 n.167 (any effort to address special access by reducing rates without permitting higher rates for switched access services would be arbitrary and capricious); *see also* Supplemental Comments of AT&T Inc. (Redacted Version) at 31 (Aug. 8, 2007) (ARMIS data show that switched access rates returns are at or below zero) ("AT&T Comments").

76 *See generally Developing a Unified Intercarrier Compensation Regime*, Further Notice of Proposed Rulemaking, 20 FCC Rcd 4685 (2005).

77 *NPRM* ¶ 29.

access at the conclusion of the CALLS plan.[78] As discussed below, however, the anticipated competitive constraints on special access prices have not materialized.

B. Competition in the Special Access Marketplace

The commenters adopted quite different approaches in describing the state of competition in the provision of special access. The price cap LECs submitted maps showing the presence of alternative special access facilities in their regions and supplied lists of firms that were described as competing special access providers. Special access customers, in contrast, described their continuing heavy reliance on services provided by price cap LECs and their inability to shift a significant portion of their special access demand to alternative providers.

1. The Availability of Competitive Special Access Services

The Commission should conclude that the price cap LEC claims substantially overstate the competitive significance of the entry (and potential entry) by alternative special access providers. The evidence compiled in this proceeding indicates that in most locations and for most lower capacity services, special access customers do not have competitive alternatives to the price cap LECs' offerings. Further, the evidence indicates that those few alternatives that do exist have been unsuccessful in putting downward pressure on the prices for special access services. As a result, consumers are suffering from "higher rates, lost competition, and lost innovation."[79] Thus, the incumbent LECs' assertions overstate the impact of competing providers on the marketplace for special access.

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78 *CALLS Order* ¶ 36.

79 Letter from Chris Murray, Senior Counsel, Consumers Union, to The Honorable John Dingell, Chairman, Committee on Energy and Commerce, United States House of Representatives, at 1 (Oct. 1, 2007), copy attached as Exhibit A.

For example, in contrast to the claims of competitive losses, the Commission's data show that incumbent LECs continue to control over 90 percent of wholesale special access revenues.[80] Commenters have explained that they purchase more than 90 percent,[81] in most cases, of their DS1 and DS3 circuits from incumbent LECs. Moreover, the incumbent LECs' share has continued to increase over the past several years even as demand for special access is growing.[82] According to the Commission's data, the incumbent LECs' share of the special access marketplace was 92.7 percent in 2001; by 2005, the incumbent LECs' share had grown to 94.1 percent.[83] Because special access revenues grew significantly between 2001 and 2005, these data demonstrate that the incumbent LECs are increasing their share of an increasing market. Other data in the record also confirm that the incumbent LECs' share of the special access business has grown in recent years.[84] In short, these trends[85] show that the incumbent LECs are not

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80 *See ex parte* presentation attached to letter from Anna M. Gomez, Sprint Nextel, to Marlene Dortch, FCC Secretary, at 3 (Aug. 22, 2007) ("Sprint Nextel Aug. 22 *Ex Parte*"), *citing* FCC Universal Service Monitoring Report, Table 1.5 and Telecommunications Industry Revenue Report, Table 5 (2005 percentage adjusted to include pre-merger AT&T and pre-merger MCI in-territory revenue in the ILEC percentage).

81 *See* Sprint Nextel Comments at 30; Ad Hoc Comments at 8 n.10; Comments of T-Mobile USA, Inc. at 6 (Aug. 8, 2007) ("T-Mobile Comments").

82 *But see* Reply Comments of Verizon (Redacted Version) at 39 (Aug. 15, 2007) (claiming there is more special access competition today than there was in 1999) ("Verizon Reply Comments"). Regardless of whether there has been an increase in the number of competitors, however, the more relevant fact established by the record is that competitors' collective share of special access revenues has declined since 2001. *See* Sprint Nextel Aug. 22 *Ex Parte* at 3.

83 Sprint Nextel Aug. 22 *Ex Parte* at 3.

84 *Id.* at 6-7 (Sprint Nextel's reliance on obtaining DS1s from the incumbent LECs (for office building connections) has grown from an average of 88 percent in 2001 to 96 percent in 2006. Similarly, Sprint Nextel's purchases of DS3s from the incumbent LECs (to office buildings) have increased from an average of 73 percent in 2001 to 84 percent in 2006.).

losing market share to new entrants as the Commission predicted they would in the *1999 Pricing Flexibility Order*. In fact, they are gaining market share.

The price cap LECs' continued dominance in the provision of special access furnishes additional evidence of the significant barriers that continue to deter entry, especially in the provision of lower volume special access services.[86] As the FCC has noted, "[m]ost of the cost of providing a special access line is in the support structure, *i.e.,* the trenches, manholes, poles, and conduits, the rights-of-way, and the access to buildings, not in the fiber strand or copper wires that share the support structure, rights, and access."[87] This conclusion is supported by comments submitted in both phases of this proceeding (2005 and 2007).[88]

The comments of special access customers provide additional evidence that demand for lower-capacity special access services (*i.e.,* DS3 or below) is not attracting

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85 *See* Verizon Reply Comments at 33 (claiming that trend data is more relevant than evidence of a point in time).

86 *See NPRM* ¶ 26; *Unbundled Access to Network Elements*, Order on Remand, 20 FCC Rcd 2533, ¶ 153 (2005) ("*UNE TRRO*"); *see also* Comments of Time Warner Telecom and One Communications (Redacted Version) at 7-8, 13 (Aug. 8, 2007) ("TWTC Comments").

87 *NPRM* ¶ 26, *citing AT&T Petition for Rulemaking.*

88 *See, e.g.*, Comments of Embarq at 21 (Aug. 8, 2007) (recognizing that the cost of constructing cable plant is not variable with the bandwidths of the circuits being deployed) ("Embarq Comments"); *see also* TWTC Comments at 13-14 (noting that competitors continue to face significant barriers to entry whether provisioning Ethernet or TDM and explaining that "the economics of loop deployment do not magically improve when a different protocol is used to transmit the signal. The same trench must be dug, the same fiber must be laid and similarly priced electronics must be attached."); Comments of Time Warner Telecom at 18-19 (June 13, 2005) ("TWTC 2005 Comments"); Comments of ATX Communications Services, *et al.*, at 29 (June 13, 2005) ("ATX 2005 Comments"); Comments of Nextel Communications at 9-12 (June 13, 2005) ("Nextel 2005 Comments").

appreciable competitive entry.[89] Consequently, the incumbent LECs are often the only providers able to serve locations (such as cell sites) with low capacity demands. In these areas, the incumbent LECs have virtually 100 percent of the market share for lower-capacity special access services. According to Ad Hoc, for example, its members have found that viable competitive alternatives are available at less than 10 percent of their locations with demand for four or fewer DS1s of capacity.[90]

The comments of independent wireless carriers paint a similar picture. Sprint Nextel, for example, indicated that, in the top 50 MSAs, it purchases nearly 98 percent of its DS1 connections from incumbent LECs.[91] In Chicago, that number is 99.4 percent, while in New York it is 95.7 percent and in Boston it is 97.9 percent.[92] T-Mobile similarly explained that incumbent LECs are its "sole source" of special access services at virtually all of its cell sites.[93] Claims of increased competition for services such as wireless backhaul focus largely on future trends rather than existing competition or make

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89 Declaration of Ajay Govil, ¶¶ 19, 27 ("Govil Decl."), attached to Comments of XO Communications, LLC, Covad Communications Group, Inc., and NuVox Communications (Redacted Version) (Aug. 8, 2007) ("XO-Covad-NuVox Comments") (stating that XO will not construct facilities unless the capacity demand is at least three DS3s, and that interoffice transport routes are only justified with at least nine to twelve DS3s of traffic); *see also* Embarq Comments at 22 (carriers are less likely to construct facilities for lower capacities); Declaration of Don Eben, ¶ 4, ("Eben Decl."), Attachment 1 to Comments of ATX Communications, Inc., *et al.* (Redacted Version) (Aug. 8, 2007) ("ATX *et al.* Comments") (stating that it is rarely economical to build last mile connections at DS0, DS1 or DS3 levels to individual customer premises).

90 Comments of Ad Hoc at 8 n.10, 19. Similarly, 360 Networks (USA), ATX, and others assert that CLECs purchase BOC special access at 95 percent of CLEC customers' locations. Reply Comments of ATX Communications, Inc., *et al.*, at 4 (Aug. 15, 2007) ("ATX *et al.* Reply Comments").

91 Sprint Nextel Aug. 22 *Ex Parte* at 5.

92 *Id.*

93 T-Mobile Comments at 6.

only generalized comments about increased market entry rather than identifying the geographic availability of the purported emerging competitive alternatives.[94] Thus, there is little specific, concrete evidence in the record to dispute the evidence filed by buyers of lower-capacity special access services that they have few, if any, alternatives to the incumbent LECs in almost every geographic area.

The price cap LECs do not directly challenge this evidence of continuing dependence on their special access services. Rather, they generally contend that there has been widespread competitive entry by special access providers, citing maps of competing facilities in their regions and lists of firms claiming they currently offer special access.

These contentions, however, fall well short of showing that price cap LEC-provided special access services face effective competition. Although there are competitive alternatives to the incumbent in some areas, those areas tend to be along routes with very high traffic volumes that can justify the deployment of facilities with very high maximum rates (such as OC48 and above). This evidence of competitive entry does not refute the showing that competition in the provision of lower-capacity special access services is sporadic, especially in remote areas, such as cell site locations or non-urban buildings.

Further, lists of providers offering special access services do not shed light on the effectiveness of these providers as competitive alternatives.[95] The record lacks sufficient data about these providers' offerings, the prices they charge, or the locations they serve,

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94 *See, e.g.*, AT&T Comments at 14-15; Verizon Comments at 26-28; Qwest Comments at 39-40.

95 *See, e.g.*, Comments of the United States Telecom Association at 14-16 (Aug. 8, 2007) ("USTelecom Comments"); Verizon Comments at 20-27; AT&T Comments at 15-21; Qwest Comments at 29-39; and Embarq Comments at 5-8.

to support a conclusion that their presence ensures a competitive special access marketplace. To the contrary, the weight of the evidence indicates that these providers do not offer a meaningful alternative to incumbent LEC special access services in most geographic locations, to most buildings or to most cell sites.[96]

The price cap LECs also point to competition from intermodal alternatives.[97] The record indicates, however, that intermodal alternatives to incumbent LEC special access services are neither sufficiently developed nor adequately pervasive to serve as an effective competitive constraint on the incumbent LEC's prices.[98] For example, in 2006, Sprint Nextel purchased 84 percent of its DS3s to office buildings from the incumbent LEC.[99] Sprint Nextel and T-Mobile also have indicated that cable companies have not made significant competitive inroads into the provision of special access serving wireless cell sites.[100] Ad Hoc has also stated that cable modem service is not a factor for large business users due to the limited deployment of cable infrastructure in business areas and

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96 *See* GAO Report at 12 (facilities-based competitors serving, on average, less than 6 percent of the buildings with at least a DS1 level of demand); Declaration of Gary B. Lindsey, ¶¶ 3-5, Attachment 1 to Sprint Nextel Comments (Sprint Nextel noted the existence of 77 alternative special access vendors in the marketplace, but those vendors had fiber facilities at only about one percent of Sprint Nextel's cell sites.).

97 *See, e.g.*, Verizon Comments at 20-24; Qwest Comments at 28-39; AT&T Comments at 14-21.

98 *See* Govil Decl. ¶¶ 22-24 (cable companies do not offer wholesale access services to competitors and, even if these services were available, the cable companies cannot offer sufficient service level guarantees to support competitive services).

99 Sprint Nextel Aug. 22 *Ex Parte* at 7.

100 *See* Sprint Nextel Reply Comments at 12-13; T-Mobile Comments at 6-7; T-Mobile Reply Comments at 2-3.

the severe security and reliability concerns raised by cable-based services and technologies.[101]

Similarly, although some competitive carriers are able to self-provision special access services using microwave technology in limited instances,[102] the economics and technical limitations of microwave technology appear to preclude its use for special access services except at a small number of locations.[103] Thus, the record does not support a conclusion that self-provisioning through microwave technology imposes sufficient competitive pressure to constrain the incumbent LECs' prices for special access services. Accordingly, it would be premature to use alleged intermodal competition as a basis for granting price cap LECs greater special access pricing flexibility.

Finally, some commenters criticize the arguments of the special access customers on the ground that they present only a backward-looking "snapshot" of the special access marketplace today. These commenters contend that in the future the growing demand for broadband will foster greater competitive entry. These commenters further assert that nascent technologies, such as WiMAX, potentially may provide a substantial alternative to incumbent LEC special access services.[104]

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101 *See* Ad Hoc Comments at 7.

102 *See, e.g.*, Declaration of Steven Sachs, ¶ 13, Attachment 2 to Reply Comments of Nextel Communications (July 29, 2005) ("Nextel 2005 Reply Comments"); Verizon Reply Comments at 32 (claiming that Verizon's wireless affiliate's network uses microwave technology for backhaul).

103 *See, e.g.,* Govil Decl. ¶ 21 (stating that fixed wireless is not an option); Comments of BT Americas Inc. at 8-9 (Aug. 8, 2007) ("BT Americas Comments"); ATX *et al.* Reply Comments at 6.

104 Verizon Reply Comments at 31, 33; *see also* AT&T Comments at 15-16; Qwest Comments at iii, 39-41.

The short answer to these arguments is that they do not address the lack of competitive alternatives to the price cap LECs' special access services today. Indeed, the Commission should be especially wary of such predictions, given the inaccuracy of such predictions in the past. Moreover, although WiMAX and other new technologies may be promising, there is no evidence that they currently provide a meaningful alternative to incumbent LEC special access services. As noted above, in excess of 90 percent of special access services – particularly to cell sites – are currently provided by the incumbent LECs. The mere potential of future technologies to offer an alternative, without more, provides an insufficient basis for extending pricing flexibility to the incumbent LECs for their provision of special access services.[105]

2. Prices for Special Access Services

As noted, the Commission has a statutory obligation to ensure that special access services are offered at just and reasonable rates.[106] The weight of the evidence in the record indicates that the incumbent LECs' prices for special access services, including those subject to price indices, do not satisfy this standard. Specifically, the evidence demonstrates that: (1) special access prices are significantly higher than prices for functionally equivalent unbundled network elements ("UNEs"); (2) special access prices are substantially higher than prices for similar capacity broadband services offered at retail in competitive markets; and (3) incumbent LECs have earned increasing rates of return on special access services.

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105 As discussed in section IV, claims that these alternatives will become competitive are addressed by the adoption of an effective trigger mechanism that will deregulate incumbent LEC special access prices at such time that these alternatives put competitive pressure on the incumbent LEC's prices.

106 *NPRM* ¶ 59 (*citing* 47 U.S.C. § 201(b)).

Several commenters provided data comparing special access prices to the rates charged for functionally equivalent UNEs. For example, Sprint Nextel compared the five-year term price (the most favorable price buyers receive from an incumbent LEC) for a DS1 circuit to the month-to-month UNE price of a functionally equivalent DS1. Comparing those prices in nine different states, Sprint Nextel's analysis showed that the special access price, on average, is nearly twice the UNE rate for the functionally equivalent network element.[107] Because UNE rates are designed to reflect the forward-looking cost of the element involved and are determined through an administrative process in which the incumbent LEC is a key participant, these rates are indicative of the actual economic cost of the relevant facility.[108] The fact that incumbent LECs' special access rates are nearly twice as high as those for comparable UNEs suggests that special access rates are neither cost-based nor just and reasonable.

Commenters also noted that special access services are priced significantly higher than comparable services offered in competitive broadband markets.[109] As Verizon has acknowledged, broadband services such as DSL and FiOS provide speeds that are "comparable to or greater than DS1 facilities."[110] Despite these similarities, however, the evidence demonstrates a substantial contrast in prices. The monthly prices for DSL, cable modem service and Verizon FiOS, for example, are approximately $30 to $40; a

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107 Sprint Nextel Aug. 22 *Ex Parte* at 10; *see also* Comments of the Office of Advocacy, U.S. Small Business Administration, at 7 (Aug. 8, 2007) ("SBA Comments").

108 *See* Embarq Comments at 20 (forward looking costs are more appropriate than ARMIS for measuring the costs of special access services).

109 *See* Sprint Nextel Aug. 22 *Ex Parte* at 11 (AT&T's Elite DSL service provides speeds of 6/.8 Mbps, Verizon's Power Plan DSL service provides speeds of 3/.8 Mbps, Time Warner's Road Runner Service provides 5 Mbps, and Verizon's FiOS provides speeds of 5/2 Mbps.).

110 Verizon Reply Comments at 35.

special access DS1 circuit purchased from the incumbent LEC costs, on average across nine states, $390 per month.[111] Although there are differences between special access services and the other broadband services that may justify some price differential – for example, DSL, cable modem and FiOS offer a "best efforts" level of service while special access services are dedicated[112] – the differences are not sufficient to justify a ten-fold price differential. In addition, BT Americas submitted a comparison showing that special access prices in the United States are materially higher than prices for similar services in the United Kingdom.[113] The substantial difference in prices between similar services indicates that the incumbent LECs' rates for special access services are unjust and unreasonable.[114]

The record also demonstrates that incumbent LECs have earned increasing rates of return on special access services in recent years. An analysis of the ARMIS data demonstrates that incumbent LEC rates of return since 2000 have exceeded those that

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111 Sprint Nextel Aug. 22 *Ex Parte* at 11 (comparing prices for AT&T Elite DSL, Verizon Power Plan DSL, Time Warner Road Runner, and Verizon FiOS to the average price charged across nine states for a DS1 circuit (2 channel termination and 10 miles of transport) under a five-year term plan).

112 Verizon Reply Comments at 10 ("[A] DS1 provides a guaranteed level of service, while DSL and FiOS generally provide best efforts Internet access."). The prices for DSL, cable modem and FiOS also frequently include other services in addition to access, such as electronic mail and, in some cases, video services that are not included in the price for special access services. Moreover, the reason Verizon does not guarantee the speeds of its FiOS services, for example, has less to do with the dedicated connection between the customer's premises and Verizon's central office than with the limitations of the inside wiring at the customer's location and the vagaries of the Internet. *See* FiOS Internet Disclaimer, *available at*: <http://www22.verizon.com/content/consumerfios/>.

113 BT Americas Comments at 16-17 and Attachment A.

114 The record also includes evidence showing that inbumbent LECs' prices for OCn services are well above costs. *See, e.g.*, attachments to letter from Jonathan Lechter, Counsel to TWTC, to Marlene Dortch, FCC, WC Docket Nos. 06-125, 05-25 (Sept. 18, 2007) (showing that TWTC's prices for OCn circuits are significantly lower than the prices charged by AT&T, Verizon or Qwest).

would be expected in a competitive marketplace, and that those rates of return continue to rise each year.[115] As demonstrated in the record, Verizon's rates of return have increased from 15 percent to 52 percent since 2000, and AT&T's (formerly SBC and BellSouth) rates of return have increased from 40 percent to 100 percent over the same time period.[116] These increasing rates of return refute claims that the incumbent LECs are facing the pressures of a competitive market.[117] Instead, these rates of return indicate a lack of competition to constrain prices and support a conclusion that current special access rates are unjust and unreasonable.

III. MODIFICATIONS TO THE FCC'S PRICE CAP REGULATION OF INCUMBENT LECS' SPECIAL ACCESS SERVICES

The foregoing discussion shows that price cap incumbent LECs remain dominant in the provision of special access services, notwithstanding the explosive growth since 2000 in the demand for such dedicated telecommunications links and the Commission's efforts, through the CALLS plan and other initiatives, to promote efficient, competitive entry. The Commission, therefore, should adopt the tentative conclusion set forth in the

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115 *See, e.g.*, Ad Hoc Comments at 3; Comments of the New Jersey Division of Rate Counsel at 18-19 (Aug. 8, 2007) ("NJ Rate Counsel Comments").

116 *See* Sprint Nextel Comments at 8. As noted above, even if the separations freeze does lead to an understatement of reported special access expenses, as the incumbent LECs claim, it is highly unlikely that the separations freeze could account for increases of earnings at this rate. *See also* section III, *infra*.

117 As noted above, the incumbent LECs criticize the use of ARMIS data in this manner. They claim that ARMIS data do not track economic costs and do not serve a ratemaking function. ARMIS data may be imperfect indicators of special access rates of return, but no party has submitted more accurate cost data in response to the Commission's invitation to do so. *NPRM* ¶ 29. Moreover, as explained above, the trend information is relevant even if the absolute numbers are not entirely accurate.

2005 Special Access NPRM that special access services provided by those incumbent LECs should be regulated under a price cap regime.[118]

The central element of a price cap regime is the PCI. The PCI limits the prices that a regulated carrier may assess for services subject to the price cap. To determine whether incumbent LEC prices for covered services are within the PCI, price cap carriers are required to calculate an Actual Price Index that reflects the weighted sum of the percentage change in prices.[119] Downward adjustments to the PCI over time encourage price cap LECs to become more productive while rewarding their efficiency gains by allowing them to retain reasonably higher earnings.[120] The PCI has three components: 1) an inflation measure; 2) a productivity factor or X-factor; and 3) a factor to account for cost changes that are outside a regulated carrier's control and are not otherwise reflected in the inflation adjustment.[121]

A. Productivity Factor or X-Factor

The Commission over the years has adopted several different productivity factors that were intended to reflect the price cap LECs' historic productivity performance as well as a "consumer productivity dividend."[122] Initially, the LECs were allowed to choose between a minimum X-factor of 3.3 percent and an optional X-factor of 4.3

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118 *NPRM* ¶ 24.

119 *1990 LEC Price Cap Order* ¶ 227.

120 *Id.* ¶¶ 2-3.

121 *Id.* ¶ 48.

122 The Consumer Productivity Dividend was intended to permit consumers to share partially in the benefits of the enhanced productivity incentives created by the replacement of rate base rate of return with price caps. *See Price Cap Performance Review for Local Exchange Carriers*, First Report and Order, 10 FCC Rcd 8961, ¶ 99 n.160 (1995) ("*1995 Price Cap Review Order*").

percent. In addition, incumbent LECs were required to share their interstate earnings above specified levels with their customers by reducing the PCIs in a future rate year. In 1995, the Commission increased the base X-factor to 4.0 percent and established two optional X-factors of 4.7 and 5.3 percent. Carriers electing a 5.3 percent X-factor were relieved of any potential sharing obligation based on their interstate earnings.[123] The Commission subsequently prescribed a unitary X-factor of 6.5 percent and eliminated all sharing requirements. The new X-factor was based on an assessment of historical LEC total factor productivity ("TFP") performance.[124] The D.C. Circuit reversed and remanded the 1997 order and directed the Commission to expand its explanation of the basis for prescribing a 6.5 percent X-factor (6 percent productivity offset plus .5 percent consumer productivity dividend).[125] Although the Commission initiated a rulemaking proceeding in 1999 to address the remand, the subsequent adoption of the CALLS plan rendered moot the remand and the issue of prescribing a prospective X-factor.

The *CALLS Order* implemented a proposal submitted by an *ad hoc* group of price cap LECs and interexchange carriers for a phased reduction in switched access charges to a targeted level over a period of years, beginning in 2000.[126] With respect to special access, the Commission set the X-factor equal to 3 percent in 2000,[127] 6.5 percent in

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123 *Id.* ¶¶ 19-20.

124 *1997 Price Cap Review Order* ¶¶ 18-143, 165, & App. D.

125 *USTA v. FCC*, 188 F.3d at 531.

126 *CALLS Order* ¶ 151.

127 A substantial number of the petitions for and grants of Phase II pricing flexibility occurred while the X-factor was set at 3 percent. Consequently, special access services that were removed from price cap regulation during that period were not subject to downward adjustment by the 6.5 percent X-factor.

2001, 2002 and 2003, and then equal to inflation (as measured by the GDP-PI) for 2004 and 2005.[128]

Prior to implementation of the CALLS plan, the X-factor put ongoing downward pressure on price cap LECs' PCIs, including the PCIs governing special access rates. Since July 2004, however, the X-factor for special access has been set equal to the rate of inflation (GDP-PI) and, consequently, the PCIs have not been adjusted downward.

In the *2005 Special Access NPRM*, the Commission observed that the BOCs in recent years have earned "special access accounting rates of return substantially in excess of the prescribed 11.25 percent rate of return that applies to rate of return LECs" and invited comments on whether this was a "valid benchmark for determining the need for an X-factor, or an X-factor that is higher than the factor under the CALLS plan or the pre-CALLS price cap regime."[129] The Commission also asked particularly for comments on the effect of DSL revenues on the reported special access rates of return.[130]

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128 *CALLS Order* ¶¶ 149, 151, 172.

129 *NPRM* ¶ 35.

130 *See id.* ¶ 63. As an initial matter, it is not clear that the incumbent LECs have been including DSL revenue in reporting their special access revenues. At most, the BOCs should only be including wholesale DSL revenues in their ARMIS reports. *See Appropriate Framework for Broadband Access to the Internet over Wireline Facilities*, Report and Order and Notice of Proposed Rulemaking, 20 FCC Rcd 14853, ¶ 136 (2005) (broadband Internet access service provided to end users is and "always has been, an information service. An incumbent LEC that offers this service must continue to account for it as a nonregulated activity.") ("*Wireline Broadband Classification Order*"). These wholesale revenues are unlikely to have a significant effect on ARMIS-based rates of return. Moreover, to the extent that the incumbent LECs have booked DSL revenues to special access accounts, they could have submitted restated reports showing their returns without DSL revenues. The incumbent LECs have declined to file such restatements. Accordingly, the Commission should assume that excluding DSL revenues from the calculation would not have a material effect on the incumbent LECs' rates of return.

As noted above, ARMIS data show that price cap LECs – at least the BOCs – have realized significant growth in special access operating revenues while their operating expenses and average net investment have declined.[131] The ability of price cap LECs to increase substantially their special access revenues, while associated expenses and investment have grown more slowly (or even declined), indicates that those firms have realized significant productivity gains. The price cap LECs, however, vigorously object to any use of special access ARMIS data in this proceeding. Verizon, for example, contends that ARMIS data "cannot meaningfully be used to calculate rates of return for individual services or to assess trends in such returns."[132] AT&T similarly contends that '[t]he Commission could not lawfully even take ARMIS data into account without undertaking a complicated rulemaking proceeding to undo the separations freeze, to make substantial adjustments to the ARMIS data to bring them up to date, and to establish a new rate of return appropriate to special access."[133]

In the *2005 Special Access NPRM*, the Commission pointed out that it previously has examined the LECs' historic productivity rates on the basis of their total firm performance, including switched as well as special access services. Because this proceeding concerns only the rates and rate structure of special access service, the *2005 Special Access NPRM* invited parties to comment on whether it was possible to estimate and apply an X-factor for special access services alone.[134] Alternatively, the *2005*

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131 *See* section II.A, *supra*.

132 Verizon Reply Comments at 7.

133 AT&T Reply Comments at 48.

134 *NPRM* ¶ 37.

Special Access NPRM inquired whether it would be reasonable to apply an X-factor developed on the basis of a total factor productivity study only to special access services.

The price cap LECs contend that it is impossible to estimate accurately an X-factor that is based solely on special access performance data. AT&T, for example, asserts that "the Commission has never attempted to determine an X-Factor for a single service, nor has any proponent of re-regulation proposed a coherent method for doing so."[135] The price cap LECs also challenge the studies submitted by other parties in this proceeding that purport to measure recent productivity gains of incumbent LECs on the basis of special access factors.[136]

The incumbent LECs' arguments are misplaced. Sprint Nextel has not asked (and does not expect) the Commission to set an X-factor based on a special access-specific study. The X-factor would be based on total factor productivity for all services, as was the 5.3 percent X-factor that parties have suggested using on an interim basis. As Ad Hoc, Sprint Nextel and others have explained, however, productivity analyses of the price cap LECs' special access offerings provide useful data in assessing their performance. Analyses of special access revenues and investment provide insight into both the productivity gains the incumbent LECs have made, and the lack of competition they face, in the provision of special access. As noted above, to the extent that price cap LECs have been able to increase their revenues from special access while their special access expenses grew much more slowly and their net special access investment declined, it

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135 AT&T Reply Comments at 54.

136 *See, e.g.,* Verizon Reply Comments at 7-8, 57-58.

would appear that these companies have achieved significant productivity gains.[137] The evidence that special access has experienced such large productivity gains, coupled with the fact that special access today accounts for a much more substantial portion of total firm output than it did when the Commission previously examined this issue,[138] underscores the fact that using an historic X-factor for special access would be conservative, as it would likely understate actual productivity.[139]

The record in this proceeding has not produced to date a definitive study of the price cap LECs' recent productivity performance that is comparable to the studies on which the Commission has relied in the past to prescribe an X-factor. Nonetheless, it would be unreasonable for the Commission on the one hand to conclude that the price cap LECs' continuing dominance in the provision of special access services requires the imposition of price cap regulation of those services and on the other hand to defer any relief pending the completion of a more definitive analysis of their recent productivity performance. In these circumstances, it would be prudent for the Commission to prescribe an interim X-factor that reflects a conservative estimate of the price cap LECs' historic performance, pending adoption of a more permanent factor. Courts have

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137 Reply Comments of Sprint Nextel at 37 (Aug. 15, 2007) ("Sprint Nextel Reply Comments"); Sprint Nextel Comments at 9-10.

138 *See* Sprint Nextel Comments at 39-40 (special access accounts for over 51 percent of BOC interstate telecommunications revenues today, compared to only 13 percent in 1990.)

139 In addition, the Total Factor Productivity study submitted by Sprint Nextel concludes that the incumbent LECs have experienced much higher productivity than other firms in the economy. Sprint Nextel Reply Comments at 36; Sprint Nextel Comments at 19-20 and Exhibit 2. *See also* Economics and Technology, Inc., "Special Access Overpricing and the US Economy," attached as Appendix 1 to Ad Hoc Comments, at 4 (arguing that the fact that incumbent LECs have been able to capture the full extent of their significant productivity gains has led to "extreme levels" of earnings, resulting in returns that are "unheard of in competitive markets.") ("ETI White Paper").

repeatedly upheld the Commission's discretion to fashion an interim remedy to address a problem until it could complete its deliberations on the issue.[140]

The Commission previously prescribed an X-factor of 5.3 percent in 1995 as one of three options available to price cap LECs.[141] There is substantial evidence in this record indicating that the BOCs continued in recent years to achieve significant productivity gains in the provision of special access service. Moreover, although the price cap LECs criticize the use of special access ARMIS rate of return data, it would appear that because the total interstate earnings of the BOC are well below their special access rates of return, they have been able to realize greater efficiencies, and therefore higher returns, in their provision of special access than in their provision of switched access.[142] Thus, it is reasonable for the Commission to select 5.3 percent as an interim productivity factor,[143] particularly because that factor was developed on the basis of an assessment of the total firm productivity of the price cap LECs, not just their special access performance. Further, for the reasons discussed below, because the Commission

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140 *See, e.g., Competitive Telecomms. Ass'n v. FCC*, 309 F.3d 8, 14-15 (D.C. Cir. 2002) (upholding interim restrictions on the unbundling of EELs) ("*CompTel v. FCC*"); *MCI v. FCC*, 750 F.2d 135, 141 (D.C. Cir. 1984) (upholding FCC's interim freeze of the subscriber plant factor); *ACS of Anchorage, Inc. v. FCC*, 290 F.3d 403, 408, 410 (D.C. Cir. 2002) (upholding FCC's interim jurisdictional classification of ISP-related costs for purposes of advancing a "substantial policy objective").

141 *1995 Price Cap Review Order* ¶ 199.

142 *See, e.g.,* AT&T Comments at 31 (stating that the same ARMIS data cited for claims of excessive special access returns "yields switched access returns that have long hovered near zero and have often been negative").

143 The adoption of 5.3 percent as an interim X-factor also provides greater protection for price cap LECs against the risk of a rapid increase in inflation than the current regime. Because the X-factor is set equal to inflation, if GDP-PI increased to a rate of 5.5 percent, X would equal 5.5 percent and there would be no PCI adjustment. Under the interim proposal, if inflation increased at a rate above 5.3 percent, the price cap LEC would be permitted to increase its PCI equal to the amount of the increase in the rate of inflation above 5.3 percent, *e.g.*, by 0.2 percent in the example.

should not impose any sharing obligations as part of this price cap regime, the price cap LECs will not have any disincentives to improve their productivity performance on a going-forward basis.

B. Growth Factor

The Commission has sometimes included a "g" factor as part of a price cap regulatory scheme. The purpose of a "g" factor is to account for the fact that in certain circumstances average per unit costs decrease as demand increases. In the initial price cap regime for incumbent LECs, for example, the Commission adopted a "g" factor as part of the formula for the common line basket.[144] The carrier common line charge was a per-minute rate that was intended to recover fixed, per-line costs and, as a result, increases in usage did not cause the carrier to incur significant additional loop costs. The Commission used the "g" factor to reflect the per-minute growth per access line and allocated the benefits of the usage growth equally between carriers and their customers by dividing the factor by 2. Some parties have argued that there is no need for the Commission to adopt a "g" factor for special access.[145] Other parties disagree, however, asserting that any plan adopted by the Commission should allow for a "g" factor to account for additional efficiencies that may flow from increased demand.[146]

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144 *1990 LEC Price Cap Order* ¶¶ 55-73.

145 *See* Comments of Qwest Communications International, Inc., at 14-15 (June 13, 2005) ("Qwest 2005 Comments"); Comments of Verizon at 43-44 (June 13, 2005) ("Verizon 2005 Comments").

146 *See* Comments of the Ad Hoc Telecommunications Users Committee at 47-48 (June 13, 2005) ("Ad Hoc 2005 Comments"); *see also* Comments of T-Mobile USA, Inc. at 19-20 (June 13, 2005) (Commission should account for both firm-wide productivity growth as well as increases in scale economies through mechanisms such as the X and "g" factors) ("T-Mobile 2005 Comments").

The ARMIS data suggest that growth in special access lines does not produce a proportional increase in special access costs. Consequently, it would be appropriate for the Commission, as part of a long-term price cap plan, to consider adopting a "g" factor that would capture the benefits of the growth in special access demand. For purposes of an interim price cap plan, however, it would be prudent for the Commission to decline to adopt a "g" factor at this time. The effect of excluding a "g" factor from an interim plan is to give all of the benefits of the growth in demand to the price cap LECs, pending adoption of a longer term plan. This effectively reinforces a price cap LEC's incentive to provide special access service efficiently.

C. Earnings Sharing

As part of its initial price cap regime for incumbent LECs, the Commission adopted three sharing zones for the LECs and varied the carrier's obligations under each depending on whether it elected a 3.3 percent or 4.3 percent X-factor, including a 100 percent sharing requirement if a carrier's earnings exceeded the maximum permissible levels.[147] The Commission modified the sharing obligations in the *1995 Price Cap Review Order* and ultimately eliminated them entirely in the *1997 Price Cap Review Order*.[148] The FCC concluded in its 1997 decision that "sharing severely blunts the incentives of price cap regulation by reducing the rewards for LEC efficiency gains" and represented the "last vestige of rate of return regulation."[149]

The considerations that led the Commission to eliminate sharing in 1997 remain persuasive. To the extent that sharing deters price cap LECs from reducing the cost of

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147 *1990 LEC Price Cap Order* ¶¶ 122-26.

148 *1995 Price Cap Review Order* ¶¶ 19-20; *1997 Price Cap Review Order* ¶ 148.

149 *See NPRM* ¶ 43.

providing special access service, the mechanism does not serve the public interest. It is, of course, a separate question whether price cap LECs should be permitted to retain permanently all of the benefits of efficiency gains that they achieve. For purposes of an interim price cap plan, however, the Commission should adopt its tentative conclusion that price cap LECs should not be subject to a sharing obligation.

D. Low-End Adjustment

The Commission originally adopted a low-end adjustment mechanism to protect price cap LECs against the risk that their earnings would fall more than 100 basis points below an 11.25 percent rate of return for an extended period.[150] The mechanism permitted qualifying price cap LECs to increase their PCIs in the next tariff year to a level that would provide them a fair opportunity to earn a 10.25 percent rate of return during that twelve month period.[151]

The Commission eliminated the low-end adjustment mechanism in the *1995 Price Cap Review Order* for those price cap LECs that selected the 5.3 percent X-factor and, consequently, were not subject to any sharing obligation.[152] The Commission also eliminated the mechanism in the *1999 Pricing Flexibility Order* for those price cap LECs that obtained either Phase I or Phase II pricing flexibility, but retained the mechanism for those LECs that did not qualify for or obtain that flexibility.[153]

In the *2005 Special Access NPRM*, the Commission tentatively concluded that it should retain a low-end adjustment mechanism for price cap LECs that have not obtained

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150 *1990 LEC Price Cap Order* ¶¶164-65.

151 *See id.* ¶ 127.

152 *1995 Price Cap Review Order* ¶ 20.

153 *1999 Pricing Flexibility Order* ¶ 162.

pricing flexibility as a protection against the risk of unforeseen events beyond their control that could reduce their earnings.[154] The Commission also sought comment on how the mechanism would work if it were applied to special access services only.

The 5.3 percent X-factor proposed herein is not derived from recent data and was based on studies that were not focused on special access services. Although the current productivity performance of the price cap LECs is almost certainly higher than 5.3 percent, in an abundance of caution, the Commission may choose to reinstate the low-end adjustment for all price cap LECs as long as a 5.3 percent X-factor is used rather than a figure resulting from a more recent study. That is, any price cap LEC that can show that its overall interstate rate of return during an eligible calendar year is less than 10.25 percent should be permitted to adjust its indices so that that it has a reasonable opportunity to earn that return.[155] The low-end adjustment mechanism should be available beginning with the first annual access tariff filing following the first complete calendar year during which the price cap regime discussed above is in effect. This approach would ensure that the price cap LECs are treated fairly.[156]

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154 *NPRM* ¶ 47.

155 As noted below, the 11.25 percent rate of return, which yields the 10.25 percent low-end adjustment, was derived in an era of much higher inflation than the present. *See infra*, note 294.

156 The proposed low-end adjustment and the proposal to afford a PCI increase equal to the rate of inflation above the X-factor (*see supra* note 143) provide two protections to price cap LECs that underscore the conservative nature of the interim approach. The low-end adjustment would protect an individual price cap LEC if that carrier experienced an interstate return of less than 10.25 percent, whereas the PCI increase would afford general protection to all price cap LECs in the event that economy-wide inflation exceeded the X-factor adopted for the interim plan.

E. Rate Structure – Special Access Baskets and Bands

The current special access service basket groups various services into service categories and subcategories.[157] The purpose of these groupings is to prevent price cap LECs from being able to offset price decreases for services that are more susceptible to competition with price increases for services that are less susceptible to competition.[158] Currently, there are no restrictions on a price cap LEC's discretion to reduce prices for a special access service. Upper band restrictions, however, prevent a price cap LEC from raising prices more than 5 percent above the applicable Service Band Index ("SBI"), which is a subindex for the prices for each service category or subcategory.

There is support in the record for adopting separate indices for services of different capacities.[159] For purposes of the interim rules needed to provide immediate relief, the Commission should make straight-forward modifications to the special access price cap basket. Specifically, the price cap incumbent LECs should be required to include all OCn and packetized special access service offerings in the special access price cap basket. Although the record indicates that there is not sufficient competitive pressure to constrain the prices of the incumbent LECs' interstate special access services, the evidence suggests that within a given geographic area, competitive alternatives to incumbent LEC special access offerings, although meager, do vary according to the type and capacity of the access service offerings.

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157 The current special access categories and subcategories are as follows: a) voice grade, WATS, metallic and telegraph; b) audio and video services; c) high capacity special access services and DDS services with the following subcategories: i) DS1 special access; and ii) DS3 special access; and d) wideband data and wideband analog services.

158 *See NPRM* ¶ 48.

159 *See* TWTC Comments at 44-45; Sprint Nextel Comments at 11-13.

Barring appropriate regulatory constraints, a price cap LEC could engage in strategic pricing designed to blunt the development of special access competition where it is most likely to occur. For example, if special access services were not separated by service categories, the price cap LEC could increase prices for those special access services over which it maintained the greatest market power to offset any reduction in rates for those special access services most vulnerable to the potential for competitive entry (*i.e.*, higher capacity services). Therefore, to preserve the opportunity for the growth in competition for special access services, it would be prudent for the Commission to establish separate service categories within the special access price cap basket to reflect the varying levels of the incumbent LECs' market power for these services. Separate categories should be established for: (1) DS1 channel terminations; (2) DS1 mileage; (3) DS3 channel terminations; (4) DS3 mileage; and (5) Ethernet services (including cross-connects).[160]

F. Initial Special Access Rates

The last step in establishing a new system of incentive regulation for the price cap incumbent LECs is to determine the initial rate levels for the affected services. As discussed above, the evidence compiled in this proceeding indicates that the existing rate levels for special access services subject to price indices are excessive and, thus, should not be used as the initial rates. Further, the Commission has not undertaken a comprehensive review of these rates for seven years, despite repeated statements in the past that its objective was to move access charges to forward-looking cost levels.[161]

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160 *See* TWTC Comments at 45.

161 *See 1997 Access Charge Reform Order* ¶¶ 44, 48; *CALLS Order* ¶¶ 36, 166; *NPRM* ¶ 65.

As discussed above, the record evidence indicates that today's special access services are priced well above competitive levels. Because prices are also higher in areas for which the incumbent LECs have been granted pricing flexibility than in areas in which the incumbent LECs' rates remain under price caps, and prices are higher in both areas than they would be if an X-factor above the rate of inflation had been retained as part of the Commission's price cap regime, it is necessary to reset all special access prices. In order to achieve an immediate correction to special access rates, the Commission should adopt the following interim measures.

The Commission should adopt a two-phased approach to setting the prices for special access under this new incentive-based scheme. As an initial step, the Commission should require price cap LECs to recompute their PCIs as if the X-factor used in that formula had been 5.3 percent for 2004 through 2007.[162] The price cap LECs were permitted to retain all of the benefits of their efficiency gains during the period that the CALLS plan was in effect and for two years thereafter. There is no sound public policy reason for permitting the LECs to continue to retain those benefits in the future. In addition, for the reason discussed above, the X-factor should remain at 5.3 percent in subsequent annual access filings until such time as the Commission completes a further proceeding to determine a new X-factor.

For the July 2008 annual access tariff filing, the price cap LECs should be required to reset their special access rates based on either their forward-looking costs or their historical accounting costs. Review of the data that will be needed to support these

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[162] As discussed *infra*, the Commission should promptly eliminate Phase II pricing flexibility, reduce the prices for affected service offerings to the levels of comparable services under price caps, and place the affected services under price caps. These services, thus, also would be subject to the revised price cap indices.

revised rates will be time consuming and resource intensive. Therefore, price cap LECs should file on 90 days' notice revised special access rates to be effective on July 1, 2008, based on one of the following methodologies.

First, the price cap LECs should be permitted to compute the percentage change to special access rates that would be needed to target their overall interstate earnings to an 11.25 percent rate of return and to reduce their special access PCIs by an exogenous adjustment equal to that percentage change.[163] The price cap LECs would then have to reduce their special access rates so that the Actual Price Index for the special access basket was at or below the revised price cap level, and so that any SBI limitations are met.

Use of this alternative has several advantages. Because it uses ARMIS data already filed by the price cap LECs, it would be relatively simple and expeditious to implement. In addition, because it uses the existing price cap basket and band structure, it is easily understood and would allow the price cap LECs to retain the incentives they currently have to adjust prices under the applicable indices between and among services and rate elements within the services. Moreover, it would not require the incumbent

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[163] Specifically, the incumbent LECs should use the following data from ARMIS 43-01, Table 1-Cost and Revenue: (1) row 1090-Total Operating Revenues, column (s) – Special Access; (2) row 1915 – Net Return, column (h) – Interstate; and (3) row 1910-Average Net Investment, column (h) – Interstate. The rate of return is computed by dividing the amount reported in row 1915 column (h) by the amount reported in row 1910 column (h). From that rate of return, the incumbent LECs subtract 11.25 percent, multiply the resulting difference by the amount in row 1910 column (h), and multiply the result by a tax factor that is computed by the formula 1 / (1 – tax rate), where the tax rate to be used, which is the sum of the federal and the average state income tax rates, is 39.25 percent. The result is then divided by the revenue reported in row 1090, column (s) – Special Access, to obtain the percentage exogenous change to the special access price cap indices. The Commission should delegate to the Wireline Competition Bureau the authority to review and confirm the correctness of the incumbent LECs' computations using this methodology.

LECs to develop in a short time frame allocation methodologies for assigning costs among services. Finally, because the approach is designed to produce rates that will generate an 11.25 percent rate of return on a total (switched and special) interstate basis, it addresses claims that retargeting only special access rates to earn the authorized rate of return would ignore low reported earnings on interstate switched access investment.

If the price cap LECs can demonstrate that their filed ARMIS data materially misstate their actual special access costs and revenues, they should be given the option of resetting their special access prices as of July 1, 2008, following the methodology outlined above, but based on their revised historic accounting costs.[164] Under this option, the incumbent LECs would be required to submit detailed historical and projected annual cost data similar to the data they filed under rate of return regulation and similar to the level of detail reflected in the ARMIS 43-01 and 43-04 reports. The historical cost data should be filed for the most recent calendar year available at the time of the filing, and the projected annual data should be for a 12-month period beginning on July 1, 2008. If an incumbent LEC were to choose this alternative, it should be required to describe and justify the basis on which it made any adjustments to its ARMIS data.[165] It should also be required to describe with specificity its allocation of reported costs to the various special access services, *i.e.*, DS1, DS3, OCn and Ethernet.

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164 As discussed above, it is not clear whether or by how much the ARMIS data misstate special access costs.

165 For example, if the incumbent LECs revise their costs allocated to special access by directly assigning plant, they should be required to describe with specificity the methodology they used to determine how much plant should have been directly assigned.

Finally, as a third alternative, the incumbent LECs could be permitted to reset their special access rates based on forward-looking economic costs.[166] Should it adopt this methodology, an incumbent LEC should be required to provide the Commission with support for all cost models and inputs used to compute rates. To the extent the inputs or models differ from those adopted in the state UNE proceedings, the incumbent LEC should be required to provide justification for all differences.

All of these alternatives for resetting rates as of July 1, 2008 would require extensive supporting data and review by interested parties. The Commission should delegate to the Wireline Competition Bureau the authority to review and approve these filings and to determine the format in which the data are filed.

In addition to the foregoing measures, the Commission, as discussed below, should also replace the current special access competitive triggers with standards that more accurately measure the presence of competing service providers in a relevant geographic area. Collectively, these revisions to the Commission's regime for regulating special access should move existing price cap special access prices to reasonable levels, encourage efficient competitive entry, and relax regulatory controls as competition supplants the need for such safeguards. As noted above, the Commission's previous attempt to predict the advent of effective competition for price cap LEC special access services proved imperfect. Nonetheless, there is evidence that competing services are more available today for certain services in certain limited geographic areas than at the time that price cap regulation was initiated, and the reforms recommended herein should

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166 The incumbent LECs already have forward-looking economic rates established in the states for their TELRIC-based UNE rates, but those rates are established only for DS1 and DS3 channel terminations and transport, not for Ethernet and higher capacity circuits, such as OC3 or above.

encourage greater entry in the future. The Commission, therefore, should put in place a process for eliminating all price cap regulation of special access services at a date certain in the future when it is reasonable to anticipate that the regime will no longer be necessary. A period of ten years from the date that the interim reforms take effect should provide an adequate interval for effective competition to take hold on a widespread basis. Because, however, prior predictions of nascent special access competition have proven inaccurate, the Commission should initiate a proceeding 24 months prior to the scheduled expiration of its rules that will provide an opportunity for special access customers and other interested parties to demonstrate that the provision of special access remains dominated by the price cap LECs and, consequently, the safeguards must continue in place beyond the expiration date.[167]

IV. PRICING FLEXIBILITY

The Commission adopted in 1999 "anticipatorily deregulatory rules"[168] to govern Phase I and Phase II pricing flexibility for special access. The Commission based this decision on its desire to avoid the competitive harm caused by unnecessary regulation as well as its "predictive judgment" that the competitive triggers it selected would demonstrate the presence of "sufficient competitive market entry in specific geographic markets to constrain monopoly behavior."[169] As part of this comprehensive review of special access, the Commission undertook to "examine whether the Commission's

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167 Although this proposal is limited to the elimination of price cap regulation only, when the Commission initiates its sunset proceeding, it can also consider other components of deregulation that may need to be addressed, such as forbearance from federal tariff requirements for interstate special access services.

168 *NPRM* ¶ 69 (citing *1999 Pricing Flexibility Order* ¶ 154).

169 *NPRM* ¶ 69.

pricing flexibility rules have worked as intended and, if not, whether they should be modified or repealed."[170] Indeed, the Commission underscored its "ongoing commitment to ensure that our rules, particularly those based on predictive judgments, remain consistent with the public interest as evidenced by empirical data."[171] The FCC's inquiry centered on Phase II, not Phase I, pricing flexibility "because, once Phase II flexibility is granted, price cap LECs no longer need make available their generally available price cap tariffs."[172]

As explained below, the Commission should conclude, based on substantial record evidence, that the competitive triggers it adopted in 1999 for granting price cap LECs Phase II pricing flexibility have proven to be unreliable predictors of the presence of effective competitive constraints on the LECs' exercise of market power. The comments submitted in 2005 and 2007 show that: (1) price cap incumbent LECs have used Phase II flexibility to impose "sustained and substantial" price increases for special access; (2) current special access rates are unjust and unreasonable; (3) the current pricing flexibility triggers are based on improper definitions of the relevant product and geographic markets; and (4) competitive entry has not occurred in Phase II areas to constrain the incumbent LECs' market power in Phase II areas as the Commission originally predicted. Accordingly, the Commission should: (1) repeal its existing pricing flexibility rules; (2) reduce rates charged for special access in pricing flexibility areas to rates no higher than the tariffed rates that apply under price caps; (3) place all price-cap

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170 *Id.* ¶ 71.

171 *Id.*

172 *Id.*

LECs' special access services under price caps; and (4) issue a further notice of proposed rulemaking seeking comment on new, more appropriate, pricing flexibility triggers.

A. Special Access Price Changes in Areas Where Price Cap LECs Have Obtained Phase II Pricing Flexibility

In the *2005 Special Access NPRM*, the Commission recognized that "the level of competition can be assessed by determining whether there have been *substantial* and *sustained* price increases."[173] The evidence submitted in this proceeding indicates that price cap LECs have increased interstate special access rates substantially in many of the areas in which they received Phase II pricing flexibility.[174] The GAO, for example, reported that "[s]ince phase II pricing flexibility was first granted, list prices for dedicated access that apply under phase II, on average, have increased."[175] These increases have been both substantial and sustained.[176]

For example, Verizon raised its five-year term rates for DS1 channel terminations in Phase II pricing flexibility areas in the Verizon North region, from an average of

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173 *NPRM* ¶ 73 (emphasis in the original).

174 *See, e.g.*, ETI White Paper, attached as Appendix 1 to Ad Hoc Comments, at 21-22; Global Crossing Comments at 5 (price cap LECs have used their pricing flexibility to increase rates for special access services by as much as 25 percent).

175 GAO Report at 13. *See also id.* at Tables 11 and 12 (comparing 2006 price flex prices for DS1 and DS3 services to prices charged in 2001). GAO also noted that average prices in areas with Phase II pricing flexibility are higher than average prices in Phase I and price-cap areas. *Id.* at 62. *See also* Sprint Nextel Comments at 16-17 and Exhibit 1 (comparing rates in pricing flexibility areas to rates in price cap areas); Ad Hoc Comments at 12-14.

176 *See, e.g.,* Comments of ATX, *et al.* at 9 (BOCs have "significantly raised their DS1 and DS3 special access rates where given Phase II pricing flexibility"). Although the Commission has noted that a price increase need not be large to be "substantial" (*NPRM* ¶ 74 n.188), the price increases reflected in the record have been significant – usually well over ten percent.

$114.56 in 2001 to $126.02 in 2002, and sustained that increase through 2006.[177] Similarly, Verizon raised its five-year term fixed rate for DS1 channel mileage in Phase II pricing flexibility areas in the Verizon North region from $32.50 in 2001 to $35.75 in 2002, and raised its five-year term variable rate for DS1 channel mileage from $16.17 in 2001 to $17.79 in 2002. In each case, Verizon increased its rate by approximately 10 percent and sustained the increase over a period of several years. The data for Phase II pricing flexibility areas in the Verizon South region show a similar trend: The five-year term rate for DS1 channel terminations subject to Phase II pricing flexibility increased from $135.92 in 2001 to $146.66 in 2002; the five-year term rate for DS1 mileage fixed rose from $30.33 to $35.75 and the DS1 mileage variable charge rose from $13.91 to $17.79 over the same time period. Again, Verizon increased each rate significantly and sustained the increase for a period of several years.[178]

Other price cap incumbent LECs have sustained similar price increases in areas where they have been granted pricing flexibility. For example, commenters have shown that between 2002 and 2005, then-SBC increased its rates in pricing flexibility areas by 27 percent in legacy SBC territory and by 15 percent in legacy Pacific Bell territory.[179] Similarly, there is evidence that between 2002 and 2005, Qwest increased its special

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177 Five-year term rates offer the most favorable discounts.

178 *See* Verizon Tariff F.C.C. No. 11, Sections 25, 30 and 31; Verizon Tariff F.C.C. No. 1, Sections 7 and 25; *see also* Appendix 1 to ETI White Paper, attached as Appendix 1 to Ad Hoc Comments, at A-25 and A-26, Tables A9 and A10 (showing increases in special access prices for like services since the onset of pricing flexibility).

179 XO-Covad-NuVox Comments at 11. AT&T's rates have not shown a marked increase since 2005, but that appears to be largely attributable to merger conditions that first prevented AT&T from raising Phase II special access pricing, and then required AT&T to reduce its rates for at least some special access services in Phase II pricing flexibility areas. *See* ATX *et al.* Comments at 10; *SBC/AT&T Merger Order* at Appendix F; *AT&T/BellSouth Merger Order* at Appendix F.

access rates by 62 percent in areas where it had been granted pricing flexibility.[180] Since 2005, Qwest appears to have increased its rates for DS1 facilities in Phase II pricing flexibility areas by approximately 25 percent.[181]

Some price cap LECs have challenged evidence that special access prices have increased in Phase II areas, asserting that average revenue per unit has declined.[182] For example, AT&T and Verizon claim that the average revenue per voice grade equivalent ("VGE") or per circuit has declined.[183]

As several parties point out, however, assessing price trends on the basis of changes in the average revenue per VGE can be misleading because special access prices per VGE are not constant across circuits of differing capacities.[184] Thus, a decline in revenue per VGE may be caused by a change in the mix of services customers purchase, rather than by a decline in prices.[185] For example, because of the relative prices of DS1s and DS3s, a customer will switch to a DS3 if it needs more than about 8 DS1s. If the price of 8 DS1s is exactly equal to the price of a DS3, a customer that switched from 8

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180 XO-Covad-NuVox Comments at 11.

181 ATX *et al.* Comments at 9; *see also* Comments of COMPTEL at 7 (Aug. 8, 2007) (Qwest's special access DS1 rates have increased dramatically since it obtained Phase II pricing flexibility in the Omaha MSA) ("COMPTEL Comments").

182 *See, e.g.*, AT&T Comments at 2, 8, 21-23; Verizon Comments at 2-3, 10-13.

183 Verizon Comments at 11.

184 *See, e.g.*, TWTC Comments at 34-35; Sprint Nextel Reply Comments at 15-20. Using *average* revenue in general, whether per VGE or per circuit, can be misleading. For that reason, most price indices, such as the Commission's Actual Price Index under price caps, or the Consumer Price Index computed by the Bureau of Labor Statistics, use fixed weights to average together price changes. These fixed weights ensure that any change in the index is the result of actual changes in price, not just in the mix of goods that purchasers buy.

185 *See, e.g.*, AT&T Reply Comments, RM-10593, at 27-29 (Jan. 23, 2003); *see also* Sprint Nextel Reply Comments at 15-16.

DS1s to a DS3 would see its price per VGE decline by 71 percent, as it would be purchasing 672 VGEs (a DS3) for the same price it previously paid for 192 VGEs (8 DS1s). Thus, even with no change in the price of either a DS1 or a DS3, the price per VGE for a DS3 channel termination would be significantly lower than the price per VGE for the equivalent number of DS1 channel terminations.

Moreover, if pricing trends are assessed on the basis of revenue per VGE, a modest decline in an extremely high-capacity circuit, such as an OC48 (32,256 VGEs) can mask significant increases in the prices of lower-capacity DS1 (24 VGEs) and DS3 (672 VGEs) circuits. This masking effect is significant, given that higher capacity circuits are likely to be more susceptible to competitive pressures than are lower capacity circuits.[186]

AT&T and Verizon further claim that their average prices for DS1 circuits, both under price caps and price flexibility, have declined since 2001.[187] Even if true, the fact that average prices per circuit have declined does not demonstrate that those reductions were caused by competition.[188] Price-capped DS1 services remained subject to an annual X-Factor adjustment of 6.5 percent in 2001, 2002 and 2003. Thus, regulatory requirements resulted in mandated reductions in the prices of those services. Price reductions caused by regulatory requirements cannot be used to rebut claims that price

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186 *See UNE TRRO* ¶¶154, 170; Govil Decl. ¶¶ 19, 27 (stating that XO will not construct facilities unless the capacity demand is at least three DS3s, and that interoffice transport routes are only justified with at least nine to twelve DS3s of traffic); *see also* Embarq Comments at 22 (carriers are less likely to construct facilities for lower capacities); Eben Decl. ¶ 4 (stating that it is rarely economical to build last mile connections at DS0, DS1 or DS3 levels to individual customer premises).

187 AT&T Comments at 22; Verizon Comments at 10-13.

188 *See NPRM* ¶ 75 (a firm does not possess market power if competition prevents it from maintaining price increases).

cap LECs remain dominant in the provision of special access. The sustainability prong of the Commission's "substantial and sustained" test is directed at determining whether a firm is unable to maintain a substantial price increase because there is sufficient competition to force rates down.[189] Only when competition prevents a company from sustaining substantial price increases can that firm be said not to possess market power.

In addition, reductions in average price per DS1 circuit may also be caused by shifts in demand from higher priced offerings with lower volume and shorter term commitments to plans that offer higher discounts in exchange for higher volume and longer term commitments. The availability of more favorable discounts may reflect a response to the presence of competing offerings from other providers. Alternatively, price cap LECs may make such discounts available in order to secure a greater portion of the customers' DS1 demand for a period of several years and, thereby, reduce the DS1 demand that other special access providers may compete to serve.[190] As discussed below, the record in this proceeding indicates that there has not been sufficient entry by alternative providers in Phase II areas to constrain the price cap LECs' exercise of dominance in the provision of special access services.

In addition, it is noteworthy that the Commission in the *2005 Special Access NPRM* invited price cap LECs to validate their claims that special access revenues per line are declining by submitting calculations of an Average Price Index for all special access services (including those under price caps and those under pricing flexibility); an

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189 *Id.*

190 In fact, as many commenters have noted, some price cap LECs, including AT&T and Verizon, use volume and term discount plans as a means of discouraging competition and maintaining market power. *See, e.g.,* COMPTEL Comments at 9-15; Global Crossing Comments at 8-10; XO-Covad-NuVox Comments at 28-35; TWTC Comments at 36-42; Sprint Nextel Comments at 24-29.

SBI for each special access service category and subcategory; and the revenues associated with the Average Price Index and SBIs.[191] Those calculations would have revealed the overall changes in the prices for the services included in the relevant baskets. Significantly, the price cap LECs declined to submit such calculations.

Finally, special access prices in many Phase II pricing flexibility markets are higher than the prices in price cap markets.[192] Some commenters contend that this phenomenon indicates that price caps held incumbent LEC access service rates below market levels.[193] The incumbent LECs' pricing behavior, however, is indicative of markets that are not subject to competition, particularly when viewed in combination with the lack of competitive entrants to these markets. Moreover, as discussed above, there is evidence that the rates for price capped services are, in fact, unreasonably high.[194]

Overall, the evidence submitted in this proceeding indicates that price cap LECs frequently have been able to raise prices in areas where they have obtained Phase II pricing flexibility and to sustain those increases for several years. In many instances, these prices have exceeded the rates assessed for equivalent services that remain subject

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191 *NPRM* ¶ 76.

192 Gately Decl., Exhibits 1 and 2; SBA Comments at 7; Sprint Nextel Aug. 22 *Ex Parte* at 12.

193 *See, e.g.,* AT&T Reply Comments at 27-29.

194 *See* discussion in section II.B.2, *supra* (comparing incumbent LECs' special access prices and the prices incumbent LECs charge for competitive services such as DSL and FiOS, and noting the differences between special access rates and the TELRIC-based UNE rates adopted in state arbitration proceedings); *see also* ATX *et al.* Comments at 15-16 (observing that "[i]f Verizon is able to charge such low rates for newly deployed, unamortized facilities [such as FiOS], this raises questions about why it needs to charge such high rates for lower capacity [special access] facilities that are substantially depreciated.").

to price cap regulation.[195] Although the price cap LECs offer a variety of explanations for these changes based on their claims that the marketplace is driven by competition, special access customers provide alternative explanations that are consistent with their view that the price cap LECs remain dominant in the provision of special access. In light of the evidence, discussed below, that the Commission's special access competitive triggers have proven to be significantly flawed as predictors of the presence of competitive offerings and that the special access marketplace has not experienced widespread competitive entry over the past seven years, the analysis of pricing changes in Phase II areas since 2000 presented by the special access customers is, on balance, more credible. That conclusion is buttressed by the fact that price cap LECs have continued to realize significant economies of scale in the provision of special access during this period,[196] but those gains do not appear to have led to reductions in price cap LEC special access rates, except where they were required to reduce prices by operation of the price cap X-factor mechanism.[197]

B. Special Access Competitive Triggers

In adopting its pricing flexibility rules, the Commission found that a showing that a price cap LEC met the triggers for Phase II relief would be sufficient evidence to ensure that competitors' market presences were significant enough to prevent the incumbent LEC from exploiting its monopoly power for a sustained period.[198] A variety of factors, both theoretical as well actual, indicate that those triggers in practice have produced

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195 *See* Sprint Nextel Comments at 16-17 and Exhibit 1.

196 *See supra*, section II.A.

197 *See* Sprint Nextel Comments at 18-21 and Exhibit 2.

198 *1999 Pricing Flexibility Order* ¶ 153.

"false positives." That is, the triggers have operated to grant the price cap LECs Phase II flexibility in areas and for products that were not subject to the competitive pressures that the Commission anticipated. Thus, pursuant to its obligation to ensure that rates for special access are just and reasonable, the Commission should repeal the Phase II pricing flexibility rules and replace them with more reliable competitive triggers.

1. Product Market Definition

Sprint Nextel and other commenters argue that the appropriate product market definition for special access services must account for differences in both function and capacity.[199] The Commission's existing pricing flexibility triggers already distinguish between special access circuits that serve different functions, because they present different barriers to competitive entry.[200] As the Commission recognized in the *1999 Pricing Flexibility Order*, new entrants are more likely to offer competing transport and other higher capacity services than to offer alternative channel termination services.[201] Accordingly, the Commission adopted a higher threshold for granting pricing flexibility for channel terminations than for other special access services.[202]

The current triggers do not, however, distinguish between special access circuits of different capacities. Verizon argues there is no need to make such a distinction because "there is no sense in referring to separate product markets for different speeds of

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199 Sprint Nextel Comments at 11; Ad Hoc 2005 Comments at 50; T-Mobile 2005 Comments at 15-16; TWTC 2005 Comments at 6; Comments of CompTel/ALTS, *et al.*, at 3 (June 13, 2005) ("CompTel/ALTS 2005 Comments").

200 *1999 Pricing Flexibility Order* ¶ 101 (finding that channel terminations warrant different treatment than other special access services).

201 *Id.* ¶ 102.

202 *Id.*

high-capacity service."[203] According to Verizon, if an incumbent LEC supplying DS3 special access services increased the price of those services, competitive suppliers of DS1 services could, by reconfiguring their facilities, offer competing DS3 service and thereby prevent the incumbent LEC from retaining DS3 demand at the higher price.[204] Other commenters disagree, however, noting that the economics of offering a competing DS1 service differ from the economics of offering alternative DS3 services. For example, commenters point out that the demand for channel termination DS1 services is too thin outside the central business district to be likely to attract stand-alone entry by competing suppliers.[205]

The Commission has previously agreed with the latter analysis, finding that where demand for high-capacity loops (equivalent to channel terminations) exists only at the DS1 level of service, there is insufficient traffic for competitive suppliers to enter by deploying DS3 facilities and channelizing those circuits to offer DS1 loops.[206] Sprint Nextel has explained that a similar analysis applies to channel mileage services: On many routes outside the central business district, demand for transport is more likely to require DS1 rather than DS3 service. In these less densely populated areas, it is unlikely that sufficient competitive DS3 transport facilities will be deployed to constrain the price cap LECs' channel mileage prices. In such markets, the price cap LEC likely would be

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203 Verizon Comments at 40, citing Taylor Supp. Decl. ¶ 17.

204 Taylor Supp. Decl. ¶ 47 ("[I]f a hypothetical monopolist of DS-3 services were to attempt to increase the DS-3 price above the competitive level, current suppliers of DS-1 services could use their present network infrastructure to provide DS-3 services and drive DS-3 profits back to a normal level.").

205 Sprint Nextel Comments at 13-16; Embarq Comments at 21-23; *see also UNE TRRO* ¶¶ 82, 166, 170-171.

206 *UNE TRRO* ¶¶ 166, 170-171.

the only provider of DS3 services, because of its scale economy advantages. In light of the significantly different economics that affect competitive DS1 and DS3 entry, the special access channel termination and channel mileage pricing flexibility triggers should distinguish between both function and capacity.

2. Geographic Market

The Commission has previously explained that the relevant geographic market for purposes of conducting a competitive analysis is an "area in which all customers in that area will likely face the same competitive alternatives for a product."[207] The current pricing flexibility triggers use the MSA as the relevant geographic market.[208] Several parties, however, contend that because competitive conditions may vary widely within a single MSA,[209] an MSA is too large a geographic area for purposes of determining whether special access services are subject to effective competition.[210] The fact that there may be competing providers offering dedicated circuits between customer premises and

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

208 *1999 Pricing Flexibility Order* ¶¶ 72-74.

209 *See, e.g.,* Sprint Nextel Comments at 13-15; Reply Comments of WorldCom, Inc., RM-10593, at 9-10 (Jan. 23, 2003) ("2003 WorldCom Reply"); Reply Declaration of Dr. Lee Selwyn, ¶ 20, attached as Exhibit 3 to Reply Comments of AT&T Corp., RM-10593 (Jan. 23, 2003) ("2003 AT&T Reply"); *see also UNE TRRO* ¶ 155.

210 *See* Nextel 2005 Comments at 7-8; Comments of Sprint Corporation at 9-10 (June 13, 2005) ("Sprint 2005 Comments"); T-Mobile 2005 Comments at 5, 14-16; *see also* TWTC 2005 Comments at 7; Initial Comments of WilTel Communications, LLC, at 21-22 (June 13, 2005).

price cap LEC central offices in some parts of an MSA does not mean that a customer that needs a circuit to connect a particular location to another price cap LEC central office in another part of the same MSA has an alternative to the price cap LEC serving that MSA.[211]

An MSA-wide market definition is also inconsistent with the economics of providing special access services. For example, providing special access service to an entire MSA would require an entrant to make a substantial up-front investment essentially to duplicate the incumbent LEC's existing network. That approach, however, would require an up-front investment in facilities along low-volume routes where there is a substantial risk that the entrant would not be able to attract sufficient demand to recoup its investment.[212] For this reason, experience has shown that new entrants do not tend to deploy their facilities on an MSA-wide basis. Rather, they target their entry to specific routes with high demand where they have the most favorable prospects for attracting adequate demand to recover their sunk investment.[213]

Moreover, the FCC rejected the use of MSAs as the relevant geographic market for both dedicated transport as well as high-capacity loops (the equivalent of channel terminations) in the *UNE TRRO*.[214] The Commission noted that an MSA-based approach

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211 *See* Sprint Nextel Comments at 14.

212 *See, e.g.*, GAO Report at 13, 26.

213 *See* Declaration of Bridger M. Mitchell, Attachment 2 to Sprint Nextel Comments, ¶¶ 30-32 ("Mitchell Decl.").

214 *UNE TRRO* ¶¶ 82, 155, 164. UNE loops are equivalent to special access channel terminations and UNE transport is the equivalent of special access channel mileage. *See, e.g., Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, 18 FCC Rcd 16978, ¶ 593 & n.1825 (2003) (drawing an analogy between a special access channel termination and a UNE loop) ("*Triennial Review Order*").

"would require an inappropriate level of abstraction, lumping together areas in which the prospects for competitive entry are widely disparate."[215] The Commission, instead, adopted a narrower market definition, based on wire centers, that takes into account routing, line density and the number of fiber-based collocators in each wire center.[216]

The Commission has previously concluded that, as a theoretical matter, the relevant geographic market for loops and transport is the geographic area served by a route connecting the two points that a purchaser seeks to link with the dedicated facility (*e.g.,* customer premises and central office, or central office and access tandem).[217] For various reasons, the Commission modified its definition and determined that the relevant geographic market for loops (channel terminations) is the wire center serving a specific customer location.[218] Channel terminations, like loops, that are provided in a geographic area served by one serving wire center are not substitutes for channel terminations provided out of another serving wire center. Similarly, the relevant geographic market for interoffice transport/channel mileage is the route between the two central offices being connected,[219] because the availability of dedicated connections between one pair of BOC central offices cannot substitute for a circuit connecting another pair of central offices.

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215 *UNE TRRO* ¶ 155.

216 *Id.* ¶¶ 66, 168.

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

218 *UNE TRRO* ¶¶ 155-161.

219 *Id.* ¶¶ 78-79.

Some commenters contend that the MSA is the relevant geographic market because incumbent LECs set prices on an MSA-wide basis. AT&T, for example, claims that its use of MSA-wide pricing means that competition in one area constrains prices throughout the MSA.[220] Other parties counter that the fact that a price cap LEC may choose to price its services on an MSA-wide or regional basis does not necessarily mean that the relevant geographic market should be similarly broad.[221] According to these parties, how incumbent LECs choose to price their services should not affect the Commission's definition of the relevant geographic market.[222] As Nextel explained in its 2005 comments, when an incumbent LEC prices uniformly across an MSA, that price reflects the variety of competitive conditions that exist across different customer routes within that MSA. As a result, MSA-wide pricing does not preclude the incumbent LECs from charging supra-competitive rates that are very close to monopoly rates.[223]

Moreover, Nextel pointed out that a LEC with pricing flexibility can reduce the influence of any competitive areas of the MSA on the uniform price, by offering specialized contract tariffs that selectively target those customers that have ready access to alternative providers.[224] By dealing with these customers through targeted contract

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220 AT&T Comments at 13.

221 *See, e.g.*, Declaration of Bridger M. Mitchell and John R. Woodbury (Redacted Version) ¶ 40 ("Mitchell/Woodbury Decl."), attached to Nextel 2005 Reply Comments.

222 *Id.* ¶¶ 40-41, 47-48.

223 For example, if most of the DS1 purchases in an MSA involve routes where there is little competition, then the price cap LEC's uniform price for DS1 links will be close to the monopoly price for those links. Under this scenario, the fact that there is uniform pricing throughout an MSA does not result in a competitive rate in all parts of the MSA. To the contrary, in this example, the BOC will charge all DS1 customers in the MSA a supra-competitive price that is very close to the monopoly rate. *See* Mitchell/Woodbury Decl. ¶¶ 42-47.

224 *Id.* ¶ 48.

offerings, the incumbent LEC can exclude them from its uniform price calculation, allowing the LEC to charge the remaining customers within the MSA a uniform price that is significantly higher than a competitive rate.[225] Moreover, the fact that price cap LECs choose to price their services on an MSA-wide basis today is no guarantee that they will continue to do so – particularly if faced with increasing competition.[226] Thus, the incumbent LECs' decision to offer uniform prices across an MSA does not change the fact that the appropriate market for policy purposes must be defined on a much more localized basis.

AT&T also claims that the majority of customer demand is contestable in those MSAs where it has gained pricing flexibility. Consequently, it claims, the threat of potential competitive entry offering alternative special access service "would be sufficient to constrain the risk of anticompetitive pricing" even where the vast majority of buildings with demand for a single, or a handful, of DS1s are served over copper facilities.[227] For markets to be contestable, however, a competitor must be able to enter rapidly and exit without requiring the entrant to absorb unrecoverable costs if it decides to abandon that market.[228] New entrants seeking to provide special access services, however, must incur substantial up-front costs which are sunk, *i.e.*, the costs are not recoverable if the entrant decides to abandon that area.[229] Further, they often must endure

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225 *Id.*

226 *See id.* ¶ 41.

227 AT&T Comments at 52-53 & n.120; *id.* at 53 ("[T]he existence of alternative facilities near a building is more than sufficient to ensure market-based prices even if the building is not currently served by alternative facilities.").

228 William Baumol, John Panzar, and Robert Willig, *Contestable Markets and the Theory of Industry Structure,* Harcourt Brace Jovanovich, 1982, at 292.

229 *See* TWTC Comments at 12-14; Sprint Nextel Reply Comments at 29.

lengthy delays before they can deploy new facilities.[230] Thus, there is little chance of "hit-and-run" entry to discipline the market power of price cap LECs. As AT&T noted in its 2002 Petition for Rulemaking, "building alternative loop and transport facilities is, in most instances, fundamentally uneconomic."[231] Moreover, the evidence of pricing changes in Phase II areas discussed above lends further support to the conclusion that special access marketplaces are not effectively contestable.[232]

3. Evidence of Competitive Entry

The price cap LECs argue that there has been substantial competitive entry throughout their service territories. USTelecom and Verizon, for example, submitted lists of companies that they claim provide competitive special access services.[233] AT&T claims that "CLECs have expanded their networks by internal growth and by merger, allowing them to continue to competitively supply new OCn level services everywhere. Their ability to supplant AT&T and to serve AT&T customers with DS1 And DS3 level demand has expanded as well."[234]

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230 *See, e.g., AT&T Petition for Rulemaking* at 31.

231 *Id.* at 25; *see also id.* at 28-32 (discussing barriers competitors face in deploying new loop and transport facilities).

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

233 USTelecom Comments at 14-21; Letter from Donna Epps, Verizon, to Marlene Dortch, FCC, WC Docket No. 05-25 (Aug. 10, 2007).

234 AT&T Comments at 10.

Despite these claims, however, the record shows that customers continue to find very few alternatives to incumbent LEC special access services in Phase II areas. For example, PAETEC states that despite "vigorous and concentrated efforts" to find alternative special access providers, it now depends on incumbent LECs for over 98 percent of its special access needs in Phase II areas.[235] Similarly, Sprint Nextel states that in Phase II areas, 97.2 percent of all Sprint Nextel's DS1s and 88.6 percent of all Sprint Nextel's DS3s were purchased from the incumbent LEC.[236] These reports are echoed by Time Warner Telecom, Ad Hoc, and API, among others,[237] and are consistent with the claims AT&T made in its *Petition for Rulemaking*.[238]

In its *1999 Pricing Flexibility Order*, the Commission acknowledged that the incumbent carriers might enjoy high market shares at the time pricing flexibility was granted.[239] The Commission, however, concluded that the triggers it adopted were sufficient to identify potential competition and that incumbent LECs would not be able to exercise market power where they faced competition from entrants using their own

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235 Comments of PAETEC Communications and US LEC Corp. at 5-6 (Aug. 8, 2007).

236 Sprint Nextel Comments at 30.

237 *See e.g.*, TWTC Comments at 12 (TWTC relies on incumbent LEC local transmission facilities to reach more locations than in the past); Ad Hoc Comments at 7-8 & n.10 (more than nine times out of ten, the incumbent LEC is the only provider available to fulfill business customers' needs for dedicated connections); Comments of the American Petroleum Institute at 6 (Aug. 8, 2007) (price cap incumbent LECs remain the predominant providers of special access services) ("API Comments"); *see also* T-Mobile Comments at 6; BT Americas Comments at 8; Global Crossing Comments at 2.

238 *AT&T Petition for Rulemaking* at 15-18 (discussing the lack of competitive alternatives to the price cap LECs); *see also* Declaration of Kenneth Thomas, attached to *AT&T Petition for Rulemaking.*

239 *NPRM* ¶ 69 (*citing 1999 Pricing Flexibility Order* ¶¶ 3, 69-70).

facilities.[240] In effect, the Commission expected that its triggers would identify the presence of adequate alternative special access facilities so that even if the initial entrant were forced out of the market, a new provider would enter to acquire and operate those facilities.

Experience has shown that the competitive triggers were based on substantially overstated estimates of the competitive effectiveness of the presence of the alternative facilities that they measured. In particular, the triggers appear to have understated significantly the high barriers to entry faced by potential competitors, discussed above.[241] As noted above, the combination of high costs and long lead times faced by new entrants makes "hit-and-run" entry infeasible.

C. Next Steps

In sum, the predictions underlying the Commission's Phase II pricing flexibility rules have proven to be erroneous. The Commission must now act to rectify the situation by adopting a new pricing flexibility regime that will reflect more accurately competitive conditions that will ensure that price cap LECs are not dominant in the provision of special access services in properly defined geographic and product markets.[242] The development of new competitive triggers will require the Commission to issue an

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240 *NPRM* ¶ 69.

241 *See supra* section IV; *see also, e.g.*, GAO Report at 13; *UNE TRRO* ¶¶ 150-153.

242 *See, e.g., Aeronautical Radio, Inc. v. FCC*, 928 F.2d 428, 445 (D.C. Cir. 1991) ("should the Commission's predictions . . . prove erroneous, the Commission will need to reconsider its [decision] in accordance with its continuing obligation to practice reasoned decisionmaking"); *CellNet Communications, Inc. v. FCC*, 149 F.3d 429, 442 (6th Cir. 1998) (deferring to the Commission's predictions about the level of competition, but stating that, if the predictions do not materialize, the Commission "will of course need to reconsider its [decision] in accordance with its continuing obligation to practice reasoned decision-making") ("*CellNet Communications*").

FNPRM seeking comment on competitive triggers that will more accurately measure the presence of competitive special access services in relevant markets.

Pending the adoption of new triggers, the Commission should eliminate the existing Phase II regime that has proven ineffective. Specifically, the Commission should repeal the Phase II pricing flexibility rules and return those services currently subject to such pricing flexibility to price cap regulation.[243] In addition, the Commission should reduce the rates for special access services that the incumbent LECs offer pursuant to Phase II pricing flexibility to levels that are no higher than the tariffed rates for such services in areas where they are subject to price caps and make such services subject to the incentive-based regulatory regime outlined above.

The steps required to bring Phase II rates under price caps are not complicated. As an initial measure, undiscounted Phase II special access rates would be reduced to the levels of undiscounted price cap rates for comparable services. The further discounts contained in the existing agreements would not be modified. Any revenue commitment levels contained in the contracts would be adjusted downward to take into account the reduction in the basic rates.[244] For example, if the basic Phase II special access rates were reduced by 20 percent and demand for Phase II special access services represented 50 percent of customers' overall special access demand, the revenue commitment would be reduced by 10 percent.

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[243] The rates associated with demand in Phase II pricing flexibility areas should be incorporated into the Actual Price Indices and relevant SBIs after they have been reduced to price cap rate levels. Thus, the value of the Actual Price Indices and SBIs will not be changed when those rates are incorporated into the indices.

[244] Some contracts do not refer to the tariffed rates, but instead list specific rates. The rates in such contracts would be reduced by an amount equivalent to the reduction in contracts that refer to the tariffed rates, and any revenue commitments would be adjusted downward to take into account the reduction in the contract rates.

Once the Phase II rates are reduced to price cap rates, the application of the 5.3 percent X-factor for the 2004-07 tariff years will require further reductions in those rates. These further reductions should also be applied to the Phase II revenue commitments. However, on a going-forward basis, only the special access rates would be adjusted annually by application of the X-factor.

V. REVISIONS TO SPECIAL ACCESS TARIFF TERMS AND CONDITIONS

Although market power is often analyzed by examining whether a firm can impose a substantial and sustained price increase, the Commission has recognized that "market power can also be exercised through exclusionary conduct. Such conduct may be evidenced from the terms and conditions contained in a carrier's tariff offerings."[245] More specifically, the Commission has long been concerned about exclusionary conduct by price cap LECs offering volume and term discounts for special access services.[246] For example, the Commission has at various times prohibited price cap LECs from offering growth discounts and limited the termination liabilities that price cap LECs could include in their tariffs.[247]

In the *2005 Special Access NPRM*, the Commission sought comment on various pricing practices employed by price cap LECs, including bundled product offerings, volume and term commitments and discounts conditioned on the customer terminating

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245 *NPRM* ¶ 114.

246 *Id.* ¶ 115.

247 *Id.* (citing *Transport Rate Structure and Pricing*, Fourth Memorandum and Order on Reconsideration, 10 FCC Rcd 12979, ¶ 17 (1995) and *Expanded Interconnection With Local Telephone Company Facilities*, Report and Order and Notice of Proposed Rulemaking, 7 FCC Rcd 7369, ¶ 202 (1992)).

service with a competitive provider.[248] In response, several parties complained that price cap LECs were engaging in exclusionary pricing practices designed to prevent competition from developing in the provision of special access services.[249] The incumbent LECs, on the other hand, claim that they are simply responding to competition by offering innovative offerings that benefit consumers by providing customers with discounts.[250] Although there is substantial evidence in the record supporting claims that at least some of the incumbent LECs' practices may have anti-competitive effects,[251] the Commission need not resolve that question definitively. Rather, the Commission should make clear that certain terms and conditions are unlawful and prohibit price cap incumbent LECs from including such terms and conditions in their special access offerings.

For example, the Commission should proscribe special access discounts that are tied to the purchase of non-special access services offered by price cap LECs. Such arrangements could permit an incumbent to use its dominance in the provision of special access to restrict competition for other goods and services. The Commission also should prohibit price cap LECs from offering discount plans that restrict customers' ability to purchase UNEs from the incumbent LEC or to purchase special access services from

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248 *NPRM* ¶¶ 119-124.

249 *See, e.g.*, TWTC Comments at 36-42; COMPTEL Comments at 9-15; Sprint Nextel Comments at 24-29.

250 *See* Verizon Comments at 7-10; AT&T Comments at 21-24; Qwest Reply Comments at 15-22.

251 *See, e.g.,* COMPTEL Comments at 9 (alleging that the BOCs' market power allows them to "extract anticompetitive terms in their contracts [which] prevent competition from developing"); TWTC Comments at 37 (incumbent LECs' discounts "are structured to ensure that monopoly rates are maintained while keeping CLEC traffic on the ILECs' networks.").

competitive providers. Such terms and conditions serve no legitimate public policy interest. They serve only to limit the ability of those alternative services to constrain special access prices. Similarly, the Commission should prohibit price cap LECs from imposing excessive penalties on customers that fail to meet volume or term commitments. Although some penalty may be appropriate, it should be limited to a reasonable level. For example, the penalty for failing to meet a volume commitment should be no greater than the difference between the price the customer was paying under its agreement and the price it would have paid under the most favorable discount available for the volume that the customer actually purchased.[252] Likewise, the penalty for failing to meet a term commitment should be no greater than the difference between the amount the customer has already paid and the amount it would have paid under the most favorable discount for which it qualifies as of the termination date.[253] Finally, the Commission should ensure that reductions in Phase II pricing flexibility rates are not erased by penalties assessed by price cap LECs on special access customers who must

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[252] For instance, if a customer received a discount in exchange for committing to purchase $10 million worth of service from the incumbent LEC, but ultimately purchased only $9 million worth of service, the penalty should be limited to the difference between the discount the customer received and the discount it should have received for a $9 million commitment. Thus, if the incumbent LEC offered a 10 percent discount on purchases of $10 million and a five percent discount for purchase of $9 million, the penalty for falling short of the original $10 million commitment should be no greater than $450,000 (*i.e.*, the difference between the $900,000 discount the customer received based on its original commitment and the $450,000 discount to which it would have been entitled had it committed to purchase $9 million worth of services).

[253] Assume, for example, that a price cap LEC offered a 10 percent discount for a 5-year commitment and a 5 percent discount for a three-year commitment. If a customer committed to purchase $10 million dollars worth of service a year over a five-year period, but terminated the contract after three years, the customer would owe a penalty of $1.5 million (the difference between the $9 million a year it had been paying under the five-year commitment plan and the $9.5 million a year it should have paid under a three-year commitment plan: $500,000 per year x 3 years = $1.5 million).

satisfy specific revenue commitments in order to obtain favorable discounts. Price cap LECs should be prohibited from penalizing a customer for failure to satisfy a revenue commitment relating to an interstate special access service formerly provided under Phase II pricing flexibility if the customer would have satisfied the commitment if the Phase II rates had remained in effect.

The Commission may also want to consider other types of provisions that have been challenged as anti-competitive.[254] Some of these practices, however, may have offsetting benefits. Moreover, several of the proposed prohibitions might involve substantial administrative difficulties and costs. At a minimum, some of these practices would require further analysis. Thus, the Commission may want to seek further comment on some of the other BOC practices described in the record, but not addressed above.

VI. THE COMMISSION'S LEGAL AUTHORITY

AT&T and Verizon contend that the Commission lacks legal authority to eliminate the current Phase II pricing flexibility regime. In addition, they maintain that the Commission may not apply an X-factor of 5.3 percent as an interim measure. They also argue that there are legal defects in each of the proposals that have been made to reinitialize rates. Contrary to those contentions, the Commission has legal authority to take each of the steps proposed herein.

A. Authority to Eliminate Phase II Pricing Flexibility

Virtually all of the contentions advanced by AT&T and Verizon, and particularly their argument that the Commission should not eliminate the current Phase II pricing

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254 *See, e.g.*, TWTC Comments at 48 (asking the Commission to prohibit any discount that is not "reasonably related" to the efficiencies created by the volume or term commitment at issue); *id.* at 49 (seeking a prohibition against volume commitments that increase over time without a corresponding increase in the applicable discount.).

flexibility triggers, are premised on the claim that special access markets are vigorously competitive.[255] But as shown above, that simply is not so. With respect to wireless service, even carriers as large as Sprint Nextel and T-Mobile are almost entirely dependent on the price cap LECs to connect their cell sites to the public switched telephone network ("PSTN"). With respect to wireline services, only a small fraction of commercial buildings are served by competitors to the price cap LECs. The price cap LECs emphasize that, in portions of many urban areas, competitive providers have deployed fiber connecting high-volume facilities such as carrier hotels and price cap LEC end-offices. But, competitive transport fiber does not permit competitive carriers to reach customers or permit wireless carriers to reach cell sites. Nor does competitive transport fiber connecting high-volume facilities in a downtown area provide a competitive alternative in other portions of an MSA. That is, contrary to the Commission's prediction when adopting the pricing flexibility rules, the deployment of collocation facilities and fiber in limited areas of an MSA does not generally discipline special access prices in the entire MSA.

For these reasons, the price cap LECs' channel termination facilities continue to be bottlenecks and there is limited competition in many areas of MSAs even when there is some competition in downtown areas. The evidence also supports the conclusion that the price cap LECs have exploited those bottlenecks, charging excessive rates that substantially exceed just and reasonable levels.

AT&T and Verizon repeatedly cite statements by the courts, the Commission, and distinguished commentators to the effect that regulation has costs and competition serves

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255 *See, e.g.*, AT&T Reply Comments at 46; Verizon Reply Comments at 41.

consumers better than regulation.[256] To be sure, if competitive alternatives were available, consumers and competition would be protected by those alternatives and there would be no need for regulation. But wishing there were competitive alternatives to the price cap LECs' special access bottlenecks does not make it so. The Phase II pricing flexibility rules the Commission adopted in 1999 were premised on the predictive judgment that, when specified numbers of competitors collocated in a price cap LEC's wire centers, the resulting competitive pressure would eliminate the need for special access regulation in the MSA. But that prediction – based on "an admittedly imperfect measure of competition"[257] – has proven to be wrong, and regulatory action by this Commission is accordingly required.

Verizon contends that the D.C. Circuit's affirmance of the Commission's *1999 Pricing Flexibility Order* in *WorldCom* precludes reconsideration of the Commission's decision to grant pricing flexibility.[258] That is a misreading of the court's decision. In fact, the court merely affirmed the Commission's discretion to formulate policy at least in part on the basis of "agency prognostications."[259] The D.C. Circuit did not in any way suggest that the Commission is forever bound by the predictions in the *1999 Pricing Flexibility Order*. But the court recognized that the Commission must be permitted to "'make pragmatic adjustments . . . called for by particular circumstances.'"[260]

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256 *See, e.g.*, AT&T Reply Comments at 1; Verizon Reply Comments at 37, 41-42.

257 *WorldCom, Inc. v. FCC*, 238 F.3d 449, 459 (D.C. Cir. 2001) ("*WorldCom*").

258 Verizon Reply Comments at 44-45; *see also* AT&T Reply Comments at 44.

259 *WorldCom*, 238 F.3d at 459.

260 *Id.* at 460 (*citing Permian Basin Area Rate Cases*, 390 U.S. 747, 776-77 (1968)).

Indeed, most of the decisions made by the Commission in the *1999 Pricing Flexibility Order* and upheld in *WorldCom* were *departures* from its prior policies. The D.C. Circuit followed the settled law that an agency is free to change its rules and policies when there is "reason to modify" those requirements.[261] Of course, the Commission must "thoroughly explain[]" why it is changing course.[262] But agencies are always required to engage in reasoned decisionmaking. In short, "[t]here is no rule against agencies adopting new policy positions. 'Everyone agrees that an agency's change of mind does not itself render the agency's action arbitrary.' . . . 'Rather, what matters is the Commission's explanation.'"[263] In this case, the failure of competition, as measured by the collocation triggers adopted in 1999, to constrain the price cap LECs' special access rates on an MSA-wide basis not only justifies regulatory adjustment, it practically compels it.

Moreover, the *WorldCom* court expressly acknowledged that the predictive judgments of the *1999 Pricing Flexibility Order*, such as using collocation measures as a proxy for actual competition, were based on "admittedly imperfect measure[s]."[264] In upholding the Commission's "predictive forecasts" about the relationship between collocation measures and actual competition, the court did not require the Commission to *continue* to rely on such imperfect measures even after better information became available. The court merely found that a "reasonable prediction deserves our deference

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261 *WorldCom*, 238 F.3d. at 460.

262 *Id.*; *see also Fox TV Stations, Inc. v. FCC*, 489 F.3d 444, 456 (2d Cir. 2007).

263 *WorldCom*, 238 F.3d at 460, *quoting Bell Atlantic Telephone Cos. v. FCC*, 79 F.3d 1195, 1202 (D.C. Cir. 1996).

264 *WorldCom*, 238 F.3d at 459.

notwithstanding that there might also be another reasonable view.'"[265] Thus, the court upheld the *specific* collocation triggers the Commission selected by noting that the Commission was "not held to a standard of perfection,"[266] but it did not preclude the Commission from changing course in light of experience.

The court also concluded that the Commission had provided an "adequate explanation" for its decision to provide Phase II relief on an MSA-wide basis,[267] but it did not suggest that the Commission could not use smaller geographic areas if experience showed that MSA-wide relief covered too broad an area. The Commission recently used geographic markets smaller than MSAs in determining when competitive carriers are impaired without the availability of high-capacity loops.[268] That issue is closely related to the issue of when price cap LEC special access rates should be fully subject to price cap rules because special access channel terminations are essentially high-capacity loops. The decision to use a more granular approach regarding UNEs supports the conclusion that it was not appropriate to use geographic areas as large as MSAs for special access pricing.

It also bears noting that the price cap LECs challenged the triggers the Commission adopted in the UNE proceeding to determine when they must provide unbundled access to high-capacity loops, claiming that the thresholds the Commission adopted required unbundling everywhere except in markets "experiencing 'extraordinary

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265 *Id., quoting Envt'l Action, Inc. v FERC*, 939 F.2d 1057, 1064 (D.C. Cir. 1991).

266 *WorldCom*, 238 F.3d at 461.

267 *Id.*

268 *UNE TRRO* ¶ 155.

levels of competition.'"[269] The court upheld the Commission's decision to rely on triggers that were more conservative than those urged by the price cap LECs, explaining: "Congress gave the Commission – not the petitioners or this Court – discretion in regulatory line-drawing. The mere fact that the Commissioner's exercise of its discretion resulted in a line that the ILECs would have drawn differently is not sufficient to make it unlawful."[270]

In short, the Commission is not bound by the predictions it made eight years ago. To the contrary, under *WorldCom*, adoption of "another reasonable view" (such as the view that pricing flexibility is *not* warranted under the standards the Commission previously adopted) based on better information (such as the showing by Sprint Nextel and other parties that special access markets have *not* become competitive) would "deserve[] . . . deference" from the courts. Indeed, in *CellNet Communications*, the court held – using words that fully apply here – that "[i]f the FCC's predictions about the level of competition do not materialize, then it will of course need to reconsider its [regulations] . . . in accordance with its continuing obligation to practice reasoned decision-making."[271] Because experience has shown that the level of competition that is present when the Phase II collocation triggers are met does not constrain price cap LEC special access pricing, the Commission should change course and the courts should respect a decision to do so.

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269 *Covad Communications Co. v. FCC*, 450 F.3d 528, 542 (D.C. Cir. 2006), *quoting* ILEC Br. at 33.

270 *Covad*, 450 F.3d. at 543.

271 *CellNet Communications,* 149 F.3d at 442.

AT&T itself made this argument convincingly in its 2002 Petition for Rulemaking initiating this proceeding. AT&T first reviewed *WorldCom* and other precedent such as *Bechtel v. FCC*,[272] which held that it is "settled law that an agency may be forced to reexamine its approach if a significant factual predicate of a prior decision . . . has been removed." AT&T then argued: "The Commission adopted its aggressive deregulation of the Bells' special access services based on a predictive judgment that competition would provide sufficient safeguards to protect against the Bells' exercise of monopoly power over special access customers. Years of data now confirm that the Commission's predictive judgment was wrong."[273] In that situation, as AT&T correctly concluded, the law does not compel the Commission to maintain a regulatory regime, such as the Phase II pricing flexibility regime, that is based on flawed predictions.

Verizon also argues that the Commission must "bear the burden of proving" that even if special access markets are not currently competitive, "future competitive entry is also unlikely."[274] This argument disregards the lessons of *WorldCom*. As discussed above, *WorldCom* affirmed the Commission's authority to *deregulate* based on a predictive judgment that admittedly imperfect measures of competition would constrain pricing. By the same token, the Commission plainly has authority to re-impose price cap rules based on the present-day reality that competition has not developed and the admittedly imperfect measures of competition that the Commission previously adopted are not adequate to ensure that special access rates are just and reasonable.

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272 *Bechtel v. FCC*, 957 F.2d 873, 881 (D.C. Cir. 1992).

273 *AT&T Petition for Rulemaking* at 38.

274 Verizon Reply Comments at 39.

Furthermore, the Commission should be very cautious in the future about deregulating in the absence of competitive pressure that is adequate to constrain price cap LEC pricing. The Phase II pricing flexibility rules were premised on a prediction that admittedly imperfect measures of competition would constrain special access rates, but the evidence shows that they have not. The Commission should be careful not to repeat its mistake and conclude that a minimal level of competition and the possibility of future competition will discipline the price cap LECs' special access rates. For example, while AT&T and Verizon do not really press the contention that wireless carriers currently have competitive alternatives to reach cell sites, they seek the Commission's authorization to continue to charge inflated rates based on the recent efforts of wireless carriers to self-deploy wireless connections to their cell sites. The Commission should not maintain its flawed Phase II pricing flexibility regime based on the hope that these efforts will bear fruit – it should wait for firm evidence that self-deployment has proven successful on a widespread basis rather than repeat the error it made eight years ago.[275] Nothing in the law prevents the Commission from taking this more prudent path.[276]

Finally, Verizon invokes the "deregulatory and competitive purposes" of the 1996 Telecommunications Act in an attempt to bolster its claim that the Commission has a special burden to justify regulation. But the Act is not blindly deregulatory, particularly where, as here, deregulation would be anticompetitive. For example, while the

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[275] Although Sprint Nextel proposes a sunset of the price cap rules, *see* section III.F, *supra*, that proposal includes a mechanism by which parties can show that sufficient competition has not yet taken hold and that the safeguards therefore must remain in place.

[276] The Commission should not disregard potential competition by means of self-deployment. The evidence shows, however, that the possibility of self-deployment by wireless carriers is not constraining price cap LEC prices today, and the price cap LECs should be fully subject to price cap regulation until self-deployment efforts are constraining prices.

forbearance provision enacted as section 10 of the Act is among its most deregulatory features, even that provision provides for deregulation only when a rule "is not necessary" to ensure that rates are reasonable and consumers are protected.[277] Section 10 does not mandate – or even support – deregulation prior to the development of competition sufficient to restrain dominant carriers from charging unreasonably high rates. Again, such competition does not currently exist in special access markets, and the Commission may therefore repeal the flawed Phase II pricing flexibility rules.

B. The Commission's Authority to Take Interim Action

As discussed above, Commission action eliminating Phase II pricing flexibility should be coupled with immediate steps to return special access rates to reasonable levels. In the short term, the Commission should place special access services previously subject to Phase II pricing flexibility back under price caps and restate applicable price cap indices at the levels that would have resulted if a 5.3 percent X-factor had been applied in the 2004-2007 annual access filings. This approach would recognize that competition has not worked to discipline price cap LEC special access prices, and would accomplish that discipline by simply re-applying the regulatory regime that was in effect prior to the Commission's adoption of pricing flexibility, while also correcting for the failure of sufficient competition to develop to justify the elimination of the X-factor.

In the *2005 Special Access NPRM*, the Commission set forth the basic justifications for this approach.[278] As the Commission stated, "[t]his record contains substantial evidence suggesting that productivity has increased and continues to increase

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277 47 U.S.C. §§ 160(a)(1), 160(a)(2).

278 *2005 Special Access NPRM* ¶ 131.

in the provision of special access services."[279] But competition has not emerged to keep prices down for consumers, and "there is currently no productivity factor in place to require price cap LECs to share any of their productivity gains with end users."[280] Accordingly, the Commission suggested that it might adopt an "interim plan" imposing "the last productivity factor, 5.3 percent, that was adopted by the Commission and judicially upheld."[281]

Both Verizon and AT&T make much of the fact that some Commission efforts to impose X-factors *higher* than 5.3 percent have been rejected by the courts as inadequately reasoned.[282] But those courts did not, of course, quarrel with the basic proposition that in a price cap regulatory regime some productivity adjustment is necessary to prevent price cap LEC special access prices from becoming unreasonable as a result of high productivity growth in the industry. In other words, there is no question that it is appropriate for consumers to "fully share in the benefits" of price cap regulation so that they do not "wind up worse off than they would have been if traditional rate of return regulation had been in effect."[283] The *USTA* and *TOPUC* courts merely found that the Commission had not given "a rational explanation of how it derived the precise percentage" allowing that sharing to occur.[284]

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279 *Id.*

280 *Id.*

281 *Id.*

282 *See, e.g., USTA v. FCC*, 188 F.3d at 525-26; *TOPUC v. FCC*, 265 F.3d 313, 328 (5th Cir. 2001) ("*TOPUC*").

283 *Bell Atlantic Telephone Companies v. FCC*, 79 F.3d 1195, 1199 (D.C. Cir. 1996).

284 *TOPUC*, 265 F.3d at 329.

In the present circumstances, the *Bell Atlantic* decision is more relevant. *Bell Atlantic*, like Sprint Nextel's proposal here, concerned the FCC's adoption of an *interim* X-factor while a sufficient record was "developed . . . to make a final or permanent determination about local exchange carrier productivity under price caps."[285] The D.C. Circuit found that "[i]n light of the interim nature of the decision . . . the Commission's decision to stick with its original methodology on an interim basis scarcely amounted to a clear error in judgment."[286] The same is true here. While – as set forth above – the Commission should allow the price cap LECs to make an updated showing on productivity levels, there is nothing arbitrary and capricious about the agency relying on a previously approved approximation of productivity for the protection of consumers while a more permanent solution is developed.[287] Indeed, the courts have consistently acknowledged that an "'agency may reasonably limit its commitment of resources'" in implementing an interim rule.[288] As the D.C. Circuit stated in *MCI v. FCC*, [289] "substantial deference by courts is accorded to an agency when the issue concerns interim relief." In the present proceeding, while Sprint Nextel does not suggest that, absent further study, the 5.3 percent X-factor should apply in the long run, it is a sensible interim step toward limiting the billions of dollars annually that consumers currently pay as a

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285 *Bell Atlantic*, 79 F.3d at 1200.

286 *Id.* at 1203.

287 *Cf. WorldCom*, 238 F.3d at 459 (explaining that the Commission's reliance on "an admittedly imperfect measure of competition does not render its use arbitrary and capricious").

288 *Competitive Telecommunications Ass'n v. FCC*, 117 F.3d 1068, 1075 (8th Cir. 1997).

289 *MCI Telecomm. Corp. v. FCC*, 750 F.2d 135, 140 (D.C. Cir. 1984); *see also Alenco Commications v. FCC*, 201 F.3d 608, 616 (5th Cir. 2000) ("Because the provisions under review are merely transitional, our review is especially deferential.").

result of the price cap LECs' supra-competitive special access revenues. Moreover, although AT&T and Verizon emphasize that the D.C. Circuit overturned the FCC's choice of a 6.5 percent X-factor in *USTA v. FCC*, it is more notable that the FCC selected that figure by choosing it from the high end of a range of reasonableness starting at 5.2 percent and the court found no fault with that 5.2 percent figure.[290] Rather, the court concluded that the FCC had failed to adequately explain its choice of an X-factor closer to the top of the range than the bottom.[291] The selection of an X-factor at the low end of the range – like 5.3 percent – would not have been vulnerable to attack by the incumbent LECs.

The use of a 5.3 percent X-factor as an interim measure is warranted because, as explained above, it is a conservative estimate of the price cap LECs' historic performance. Although none of the data presented to the Commission is perfect, the evidence showing much higher growth rates for operating revenues compared to operating expenses – a trend that has accelerated in the last few years – strongly supports the conclusion that productivity has increased substantially.[292] Using ARMIS data, Ad Hoc presented evidence supporting an X-factor of 10-11 percent.[293] Moreover, the price cap LECs are in the best position to present alternative evidence, were asked to do so, and declined.

Nevertheless, the 5.3 percent figure is not based on recent data and was based on studies that were not focused on special access services. Although the theoretically

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290 *See USTA v. FCC*, 188 F.3d at 525.

291 *Id.* at 526-27.

292 *See* section II.A., *supra.*

293 Ad Hoc Comments at 25.

correct current figure is almost certainly higher than 5.3 percent, in an abundance of caution the Commission may choose to reinstate the low-end adjustment for all price cap LECs as long as a 5.3 percent X-factor is used rather than a figure resulting from a more recent study. That is, any price cap LEC that can show that its interstate rate of return is less than 10.25 percent should be permitted to adjust its rates so that that it may obtain that return.[294] That would ensure that the price cap LECs are treated fairly.[295] Declining to adjust rates using an X-factor, in contrast, would perpetuate the status quo under which consumers of special access services have been charged rates that exceed just and reasonable rates by estimates ranging up to $8 billion annually.[296]

C. The Commission's Authority to Reinitialize Rates as a Longer-Term Solution

As noted above, eliminating pricing flexibility and reducing special access rates using the 5.3 percent X-Factor is only an interim step. In the longer run the Commission should reinitialize special access rates, and the new rates should become effective on July 1, 2008. Generally speaking, those rates could be derived either (1) using ARMIS data; (2) using new historic accounting cost data to be submitted by the price cap LECs; or (3) using new forward-looking cost data and models to be submitted by the price cap LECs. The price cap LECs should be permitted to choose among these options.

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294 There is no merit to the price cap LECs' attacks on the 11.25 percent rate of return, which yields the 10.25 percent low-end adjustment using 100 basis points to determine the adjustment. That figure was derived in an era of much higher inflation than the present. A higher rate of return might nevertheless be warranted if special access markets were as competitive as the price cap LECs claim, but they are not.

295 As noted above, the low-end adjustment mechanism should be available beginning with the first annual access tariff filing following the first complete calendar year during which the price cap regime discussed above is in effect.

296 ETI White Paper, attached as Appendix 1 to Ad Hoc Comments, at 4, 19.

Verizon, however, raises a threshold claim to reinitializing rates in *any* of these manners, baldly claiming that the Commission has no authority to do so because its "'authority to prescribe rate reductions" depends upon a "finding that current rates are or will be unreasonable.'"[297] That argument bears little further comment: As set forth in detail above, the unreasonableness of special access rates is precisely why the Commission *does* have authority to reinitialize special access rates – price cap LEC special access charges have been and continue to be unreasonable. Moreover, to the extent that price cap LEC special access rates are found to be unreasonable, there can be no principled legal objection to resetting rates to appropriate levels. Indeed, even Verizon and AT&T do not argue that the Commission generally lacks legal authority to reduce rates found to be unreasonable. Rather, the price cap LECs primarily interpose objections to the particular methods that have been proposed for arriving at reinitialized rates. Those objections are insubstantial.

1. Reliance on ARMIS Data

AT&T first argues that the method of reinitializing rates proposed in the NPRM[298] – calculating a rate of return from ARMIS data and adjusting revenues downward to reach an 11.25 percent rate of return – would fail judicial review because ARMIS data was "never intended to be used to determine service-specific returns."[299] As noted above, however, Sprint Nextel is not proposing a service-specific return.[300] AT&T further maintains that the Commission would have to "undertak[e] a complicated rulemaking

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297 Verizon Reply Comments at 56.

298 *NPRM* ¶ 64.

299 AT&T Reply Comments at 47.

300 *See, e.g.,* section III.F, *supra* (proposing special access rates be revised to target overall interstate earnings to 11.25 percent).

proceeding to undo the separations freeze" in order to "lawfully even take ARMIS data into account."[301] But while it may be true that separations issues render ARMIS data a less-than-perfect basis on which to establish new special access rates, it is not the case that doing so would be unlawful. In the absence of other public data, ARMIS is the best information regarding costs of providing special access services currently available. And the price cap LECs have had ample opportunity in this proceeding to provide correct allocations of costs, as the Commission specifically invited them to do.[302] They have simply chosen not to provide an alternative.

Once again, the D.C. Circuit's *WorldCom* decision is instructive. There, as noted above, the D.C. Circuit explained that the Commission's reliance on "an admittedly imperfect measure of competition does not render its use arbitrary and capricious."[303] The court explained that "Petitioners, for their part, offer no alternative" save one that would have been "burdensome and time-consuming."[304] The court also noted that there is nothing arbitrary and capricious about an agency decision "to make ease of administration and enforceability a consideration" in according regulatory relief.[305] All these points may be made with respect to Commission reliance on ARMIS data here. Accordingly, while – as further discussed below – the Commission should allow the price cap LECs to make a showing regarding special access costs based on either historical accounting or forward-looking costs, it would not be arbitrary and capricious for the

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301 *Id.* at 48.

302 *NPRM* ¶ 29.

303 *WorldCom*, 238 F.3d at 459.

304 *Id.*

305 *Id.*

Commission to rely on the best data it has before it where opposing parties have been given an opportunity to submit better data and have declined to do so.

Moreover, there can be no serious question that it is legally permissible to allow the LECs to choose to reinitialize rates based on ARMIS data. On reflection, they may decide that such an approach will not yield rates that differ substantially from those resulting from a fuller study of historical costs.

2. Reliance on Historical Costs

Because the ARMIS data are imperfect, the price cap LECs should be permitted to present new data on which to base reinitialized rates, and to elect between submitting either new historical accounting cost data or forward-looking cost data. The former course need not involve the submission of massive quantities of new data, but should rather take the form of such supplementation of ARMIS data as the price cap LECs think necessary to ensure its suitability for this use in reinitialization.[306]

Neither AT&T nor Verizon seriously questions the legality of the Commission reinitializing special access rates based on historical accounting costs.[307] They do, however, present some objections that are more philosophical than legal, *e.g.*, that the "Commission abandoned cost-based regulation more than 15 years ago in order to . . .

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306 However, because billions of dollars annually are at stake – billions in excessive costs that ultimately burden consumers and impede competition – the Commission should carefully consider any factual showing the price cap LECs present, while ensuring that the price cap LECs do not unnecessarily delay the proceeding.

307 In a similar context involving reductions in cable rates, the D.C. Circuit referred approvingly to a regime in which companies could opt for traditional cost-of-service ratemaking in lieu of an otherwise-mandatory rate reduction as a "safety valve" helping to validate the new rates. *See Time Warner Entertainment Co. v. FCC*, 56 F.3d 151, 169 (D.C. Cir. 1995).

replicate the efficiency incentives of a competitive market;"[308] that rate-of-return regulation is "long-discredited . . . and would put the Commission back in the business of micromanaging price cap LECs' rates;"[309] and that "cost-based regulation would be a giant step backwards."[310]

Once again, these objections miss the fundamental point of this proceeding. Because competition has not succeeded in the special access market, it cannot act to discipline prices, and the Commission is therefore obligated to take steps to ensure just and reasonable rates. In other words, while reinitializing rates might be a "step backwards" in a competitive market, it is simply a responsible and necessary action in a market in which the price cap LECs have been able to charge supra-competitive rates because of the Commission's reliance on admittedly imperfect measures of competition. Moreover, contrary to the contentions of AT&T and Verizon, the steps proposed here would not amount to a return to rate of return regulation. Rather, the Commission would merely return some price cap LECs to price cap regulation without Phase II pricing flexibility. As in 1990, when the Commission initiated the price cap regime, the Commission should use historic cost data – as an option, at least – to establish the rates subject to price caps.

3. The Option of Using Forward-Looking Costs to Reinitialize Rates

AT&T and Verizon both focus much of their fire on the possibility that the Commission might mandate the use of forward-looking costs to reinitialize rates. Again, as set forth above, the Commission could allow the price cap LECs to choose the kind of

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308 Verizon Reply Comments at 51.

309 AT&T Reply Comments at 47.

310 Verizon Reply Comments at 52.

data to be used for reinitialization of rates, and there is no legal infirmity in giving them the option of using forward-looking costs. But even if the Commission were to mandate the use of forward-looking costs to reinitialize rates, the price cap LECs are wrong in arguing that it "would be directly contrary to the Commission's determinations – and rulings of the Supreme Court and the D.C. Circuit."[311]

As AT&T correctly pointed out in its *Petition for Rulemaking*, the Communications Act requires that "'*[a]ll* charges . . . and regulations for and in connection with . . . communications service . . . shall be just and reasonable.'"[312] Section 252(d)(1), under which the Commission developed the forward-looking TELRIC methodology, mandates that the "just and reasonable" rates for network elements (UNEs) set by state commissions should be determined based on cost, and the Supreme Court's decision in *Verizon v. FCC* approved TELRIC as an appropriate method by which to set "just and reasonable" rates for UNEs.[313] Interstate special access services are essentially indistinguishable from high capacity loops, which were at issue in *Verizon.* The price cap LECs' objection to using a forward-looking methodology here thus boils down to the claim that while the Supreme Court held TELRIC to be an appropriate way to price high capacity loop facilities when they are "UNEs," it is unlawful to use a forward-looking methodology to price those same elements when they are called "special access services." So stated, the argument refutes itself.

Moreover, the UNE pricing standard is not separate from the more general section 201 pricing standard, but is simply more specific. Section 201(b) requires rates to be

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311 Verizon Reply Comments at 52.

312 *AT&T Petition for Rulemaking* at 34 (*quoting* 47 U.S.C. § 201(b)).

313 *Verizon Communications, Inc. v. FCC*, 535 U.S. 467 (2002) ("*Verizon*").

"just and reasonable,"[314] but does not specify how the Commission is to determine whether rates are just and reasonable. Section 252(d), the pricing standard governing UNEs, specifies that "the just and reasonable rate for network elements" shall be "based on the cost" of providing the network element and prohibits the use of a "rate-of-return . . . proceeding."[315] In other words, Congress specifically required rates for UNEs to be cost-based, but its decision to preclude rate-of-return proceedings suggested the use of forward-looking costs rather than historic costs. For present purposes, the key point is that section 252(d) requires "just and reasonable rates" because section 252(d) begins with that phrase and the Supreme Court held that TELRIC produces just and reasonable rates.

Forward-looking costs may be used to determine "just and reasonable" rates under section 201 as well. The Commission has broader authority under that provision than under section 252(d) – in *Verizon*, the Court stated that "responsibility for 'just and reasonable' rates leaves methodology largely subject to discretion."[316] That broad discretion includes authority to adopt an approach that the Supreme Court has upheld as producing just and reasonable rates. It is noteworthy that, because the Commission has broader authority under section 201 since Congress was less specific concerning how just and reasonable rates are to be determined under that provision, the Commission is not

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314 47 U.S.C. § 201(b).

315 47 U.S.C. § 252(d).

316 *Verizon*, 535 U.S. at 501, *citing Permian Basin Area Rate Cases*, 390 U.S. 747, 790 (1968).

required to use forward-looking costs under section 201 and may base just and reasonable rates on historic costs as well.[317]

Verizon argues that using forward-looking costs to re-initialize special access rates would depart from prior Commission precedent because the *Triennial Review* and *UNE Remand Orders*[318] purportedly found that it would be "counterproductive" and not in the "public interest" to apply TELRIC to special access services.[319] In fact, the portion of the *Triennial Review Order* to which Verizon refers states only that the "appropriate inquiry" for network elements unbundled under § 271 (rather than § 252(d)(1)) is "whether they are priced on a just, reasonable and not unreasonably discriminatory basis – the standards set forth in sections 201 and 202."[320] Because special access prices are currently *unreasonable*, there is nothing inconsistent with the *Triennial Review Order* about mandating *reasonable* rates for special access based on forward-looking costs. Similarly, the *UNE Remand Order* discussion cited by Verizon indicates that where competitors can acquire network elements at prices set by a "competitive market," there

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317 Verizon contends (Verizon Reply Comments at 54) that the Supreme Court's decision upholding TELRIC is irrelevant because the Court described section 252(d) as being "radically unlike" traditional rate-setting provisions and the goal of the provision is to permit competition to develop even though the price cap LECs control bottleneck facilities. *See Verizon*, 535 U.S. at 489. With respect to the former contention, section 252(d) is radically unlike traditional rate-making statutes because it prohibits the use of rate-of-return proceedings. *Id.* Of course, section 201 does not prohibit the use of rate-of-return proceedings, but it does not mandate their use either. With respect to the latter contention, contrary to Verizon's assertion, the record shows that the incumbent LECs control bottleneck special access facilities.

318 *Triennial Review Order* ¶ 648; *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*").

319 Verizon Reply Comments at 52.

320 *Triennial Review Order*, 18 FCC Rcd at ¶ 656.

is no need for regulated rates.[321] That is, of course, correct – but the problem here is that special access markets are *not* competitive, and prices are therefore unreasonably high. Accordingly, if the Commission acknowledges that special access markets are not competitive, there is no inconsistency between reinitializing special access rates based on forward-looking costs and the *UNE Remand Order*. Nor does the D.C. Circuit's affirmance of the *UNE Remand Order* create an inconsistency.

AT&T also argues that it would be arbitrary and capricious to employ forward-looking costs in this proceeding because there is a rulemaking in process "to reconsider virtually every aspect of the TELRIC methodology."[322] Plainly, however, if that rulemaking results in methodological changes to TELRIC, those changes can ultimately be adapted to the special access context if appropriate. AT&T also argues that it would be unlawful to apply TELRIC here because it is intended for pricing *facilities* and not *services* like special access. As noted above, this is a distinction largely without a difference in this context – the same interstate access "services" may be supplied via UNEs or via special access services over the same facilities, and calling them by a different name need not affect the rate setting process.

Most importantly, the Commission need not mandate the use of forward-looking costs, even though the Commission has previously concluded that their use sends the best signals to competitors as to when competitive entry is warranted.[323] Rather, the

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321 *UNE Remand Order*, 15 FCC Rcd at ¶ 473.

322 AT&T Reply Comments at 49.

323 *See, e.g.*, *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, 11 FCC Rcd 15499, ¶ 672 (1996) ("the prices that potential entrants pay for these elements should reflect forward-looking economic costs in order to encourage efficient levels of investment and entry").

Commission should give price cap LECs the option to use forward-looking costs. Despite their rhetoric, it is likely that some price cap LECs will choose to use forward-looking rather than historic costs. Forward-looking costs permit higher rates than historic costs in some circumstances. In addition, the price cap LECs' failure to provide useful data on which to calculate their rate-of-return using historic costs suggests that the use of that approach would result in substantial reductions in special access rates. However, a price cap LEC should be required to choose one method to reinitialize its special access rates, and should not be permitted to use one approach in one area and another approach in other areas.

D. The Commission's Authority to Adopt Rules that Affect Contracts

AT&T and Verizon challenge proposals to adjust existing contract terms.[324] As an initial matter, they do not suggest that there is any legal impediment to the manner in which many contract rates would be affected by adoption of the approach Sprint Nextel proposes. Many special access contract rates are based on prices in specific tariffs. To the extent the Commission changes its rules so that incumbent LECs must adjust their tariffs, adjustment of the contract rates should follow in a straightforward manner contemplated by the contract – and no substantial legal issue would be presented.

Moreover, there is no substantial legal impediment, under the circumstances here, to adjusting contract rates and terms, as may be warranted in some cases to bring them down to just and reasonable levels.[325] Such adjustment is equivalent to providing purchasers with the right to take a "fresh look" at the rates and terms in their contracts and, as AT&T concedes, a fresh look is warranted under Commission precedent when

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324 AT&T Reply Comments at 64-66; Verizon Reply Comments at 58-61.

325 *See* section IV.C, *supra*.

"customers that had entered into contracts . . . lacked competitive options."[326] A review of the facts here shows that special access customers lack competitive options for the vast majority of the circuits they need. Moreover, although the Commission has repeatedly referred to users of special access as being highly sophisticated customers, which is true, one aspect of being highly sophisticated is to recognize that, in dealing with a dominant seller, the best available option is probably not very good. In any event, because the contracts currently in force reflect a lack of competitive options, buyers should be entitled to reconsider the contracts in light of rules designed to bring rates and terms down to just and reasonable levels.[327]

While refusing to concede that they are earning the exorbitant rates of return indicated by the ARMIS data, AT&T and Verizon suggest that, even if they are, they ought to be permitted to keep earning them. For example, Verizon argues that if the Commission were to return rates to just and reasonable levels, "never again could a carrier make investments without the fear that the Commission might appropriate some of

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[326] AT&T Reply Comments at 65, *citing Expanded Interconnection*, 8 FCC Rcd 7341, ¶ 17 (1993); *Competition in the Interstate Interexchange Marketplace*, 7 FCC Rcd 2677, ¶ 25 (1992).

[327] The "*Mobile-Sierra* Doctrine," *see Mobile Gas Pipe Line Co. v. Mobile Gas Service Corp.*, 350 U.S. 332 (1956), and *FPC v. Sierra Pacific Power Co.*, 350 U.S. 348 (1956), does not bar modification of these contracts. As the D.C. Circuit explained, that doctrine, formulated under the Federal Power Act and the Natural Gas Act, does not prevent agencies from modifying contracts, but instead requires "supportable and reasonable explanations for how the public interest required modification of private contracts." *Texaco Inc. v. FERC*, 148 F.3d 1091, 1097 (D.C. Cir. 1998). In these circumstances, the public interest requires modification of special access contracts because parties entered into those contracts in circumstances where, contrary to the Commission's predictions, sufficient competitive pressure did not exist to ensure that rates and terms were just and reasonable. End users, competitors, and the national economy are harmed when bottleneck facilities critical to providing advanced telecommunications services are made available at excessive rates and on unreasonable terms.

the rewards years down the road."[328] There is no merit to that contention. The Commission has a statutory duty to ensure that rates and conditions are just and reasonable, and rates of return of 50 percent or 100 percent are far beyond any plausibly permissible rate of return. With inflation at relatively low levels for the last 20 years, a rate of return of 11.25 percent is higher than would be expected. Moreover, if the ARMIS rates of return are accurate – or even close to accurate – the incumbent LECs have obtained billions of dollars in each of the last few years beyond what they would have earned if rates had been just and reasonable. That precedent will provide sufficient incentive to invest.

The Commission's decision will be subject to substantial legal attack only if the Commission fails to take action. Section 201(b) plainly requires all rates and terms to be just and reasonable. Under D.C. Circuit precedent, just and reasonable rates are normally based on cost plus a reasonable profit. Although "[t]he FCC is not required to establish purely cost-based rates," it "must specially justify any rate differential that does not reflect cost."[329] Substantial evidence has been presented showing that special access rates do not reflect cost. The proposals Sprint Nextel has presented all call for a return to special access rates that reflect cost plus a reasonable profit. The FCC would need to specially justify a failure to adopt those proposals.

The incumbent LECs have failed to provide any acceptable justification for their current rates. If the Commission concludes that competitive pressures are not keeping special access rates at just and reasonable levels, as the evidence plainly shows, section

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328 Verizon Reply Comments at 56-57.

329 *COMPTEL v. FCC*, 87 F.3d 522, 529 (D.C. Cir. 1996).

201 requires the Commission to take steps to adjust rates and terms so that they are just and reasonable.

VII. CONCLUSION

For the reasons set forth above, the Commission promptly should implement the steps recommended herein for reforming its regulation of special access services provided by price cap incumbent LECs.

Exhibit A

Consumers Union
Nonprofit Publisher of Consumer Reports

The Honorable John Dingell, Chairman
Committee on Energy and Commerce
United States House of Representatives
Washington DC 20515

October 1, 2007

Dear Chairman Dingell:

On behalf of Consumers Union, I am writing to you to express our strong support for efforts to address the incumbent local exchange carriers' (ILECs') stranglehold over numerous critical special access services. As has been already clearly stated in the FCC record in this proceeding, special access services are important to consumers because many of their daily activities are dependent upon these services. When consumers place wireless calls, access the Internet or email, or use an automated teller machine (ATM), special access services often knit those transactions together.

Unfortunately, as reinforced by the November 29, 2006 GAO Report to the U.S. House Committee on Government Reform Chairman, little competition exists for these critical special access connections in much of the country, particularly for DS-3 (and below) levels. As such, the ILECs can affect consumers' ability to access services at reasonable rates. In addition, and perhaps more perniciously, the high cost of numerous special access services can also retard the innovation and introduction of new cutting edge technologies.

The record in the special access docket shows that ILEC overcharges are growing and now amount to a significant portion of the approximately $16 Billion per year that the ILECs receive for special access services—some estimates show these overcharges at almost $8 billion per year. To be clear, consumers pay for these excessive ILEC special access overcharges, through higher rates, lost competition, and lost innovation.

The Commission's record is replete with evidence that the ILECs dominate significant portions of the special access market, and are exploiting their market power to the detriment of consumers and competition. The record in this proceeding clearly documents numerous ways ILECs have used their dominance in the special access market. A number of these examples were articulated by carriers now silenced through

ILEC acquisitions – AT&T Corp. and MCI. In addition to execessive rates, one of the examples of ILEC abuses included ILEC special access "lock-in." Tariff provisions which the ILECs called "volume discounts" were really dependent upon long term commitments of nearly 100% of the customers' existing communications traffic. The common effect of these ILEC abuses was to ensure that the customer's traffic was not available to a potential competitor if one were available.

These anti-competitive contract clauses should be scrutinized; the agency should not countenance ILEC abuse of market power. We urge Congress to act to ensure that the interests of consumers, not the bottom line of phone monopolies, are made paramount in this important proceeding.

Respectfully submitted,

Chris Murray, Senior Counsel
Consumers Union