May 15, 2008

VIA ECFS

Marlene H. Dortch
Secretary
Federal Communications Commission
Washington, DC 20554

Re: Petitions of Qwest Corporation for Forbearance Pursuant to 47 U.S.C. § 160(c) in the Denver, Minneapolis-St. Paul, Phoenix, and Seattle Metropolitan Statistical Areas, WC Docket No. 07-97

The undersigned parties hereby submit the attached white paper, by Joseph Gillan of Gillan Associates, entitled "The Irrelevance of Resale and RBOC Commercial Offers to Competitive Activity in Local Markets." This paper demonstrates that no competitive weight should be attributed to RBOC resale and Commercial Offer lines in any analysis of RBOC market power.

Please contact the undersigned if you have any questions.

Respectfully submitted,

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The Irrelevance of Resale and RBOC Commercial Offers to Competitive Activity in Local Markets

It is not uncommon for industry observers to periodically develop measures of local market share including, *without comment,* the lines that competitors lease using Section 251(c)(4) Resale and the ILEC's so-called "Commercial Offers."[1] By simply including such lines without discussion, however, these analyses implicitly attribute to resale and Commercial Offer lines the same competitive weight as lines served over the competitor's own switching and/or loop facilities.[2]

The purpose of this paper is to highlight a fundamental weakness inherent with resale and the Commercial Offers – that is, that neither provides a meaningful competitive restraint on the incumbent, or a significant commercial opportunity to the competitor.[3] Unlike a CLEC leasing loops and paying the cost-based rates required by Sections 251(c)(3) and 252, a CLEC using resale or a Commercial Offer cannot meaningfully discipline ILEC exercises of market power to increase prices to the detriment of consumers.

The only conclusion that can be supported by an analysis of the lines served by resale and the RBOCs' Commercial Offers is that there is no functioning wholesale market in the local exchange. Because the lines served by these options impose no price constraint on the incumbent, or provide a meaningful commercial opportunity for the entrant, the lines should not be afforded any weight in an analysis of retail competition.

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[1] The term "Commercial Offer" is used in this paper to refer to those products provided by the Regional Bell Operating Companies ("RBOCs") as replacements for the Unbundled Network Element Platform ("UNE-P"). Although operationally comparable to UNE-P, as explained later in this paper, the prices for the RBOCs' Commercial Offers have been unilaterally established by the RBOC, at levels reflecting the RBOCs' market power and desire to protect profitability.

[2] As a general rule, competition in the small and medium business market is commonly provided by competitive local exchange carriers ("CLECs") leasing last-mile access from the ILEC connected to a CLEC-owned switch and/or router to provide service. In contrast, most residential competition today comes from the coexistent cable company that relies on its own loop facilities (i.e., the cable plant) to reach subscribers.

[3] Resale reached its zenith more than *eight years ago* and, even then, served less than 3% of the market, while the Commercial Offers have shown rapidly decaying volumes ever since their introduction.

The Competitive Irrelevance of Resale

As a practical matter, resale is structurally deficient and lacks *any* ability to constrain the market power of an incumbent. There are three reasons that resale does not limit the market power of the incumbent and should, therefore, be afforded no weight in any market share calculation used to measure the incumbent's ongoing market power.

First, resale is nothing more than the re-offering of the retail service as designed by the incumbent.[4] There is no meaningful ability for the purchasing carrier (that is, the reseller) to differentiate its product from that offered by the incumbent through innovation.

Second, the methodology used to establish the wholesale price of the resold service is to apply a simple discount to the retail price charged by the incumbent. This pricing approach has three practical effects that ensure that resale never poses a competitive limit on the actions of the incumbent:

* The "retail-less-discount" pricing structure creates a wholesale price that parallels the retail price, ensuring that resellers can never impose a competitive constraint on the incumbent's prices. This is because the wholesale price moves up with any increase in the retail price. Consequently, the ILEC is able to simultaneously raise its rivals' costs in lock-step with any desired retail rate increase, effectively ensuring that rivals match – and, therefore, reinforce – the incumbent's rate increases.[5]

* The potential profit margin (*i.e.*, the difference between the retail and wholesale price) is the same whether or not the customer purchases just basic local service or also subscribes to a variety of optional features.[6] To the incumbent, customers that purchase

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4 Section 251(c)(4) of the Communications Act of 1934, as amended ("Act") requires ILECs "to offer for resale at wholesale rates any telecommunications service that the carrier provides at retail," with Section 252(d)(3) requiring that State commissions determine such wholesale rates by "excluding [from the retail price] the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier."

5 In contrast, if an ILEC attempted to increase its prices by a small, but significant and nontransitory amount, a CLEC using cost-based UNEs would be able to design its product and set its prices as it saw fit, thereby threatening the incumbent with competitive share loss. However, In this way, a UNE-based CLEC could discipline the ILEC's price increases in a way that resale cannot.

6 Specifically, the percentage discount – and, therefore, relative profit margin – remains constant, although the per-line margin may increase somewhat as revenues increase. It is common for profitability to be judged as a percentage of revenue and, in the final analysis, this mathematical difference between measuring profit as a percentage or in absolute dollars does not change the fundamental unattractiveness of resale as an entry strategy.

multiple features comprise a highly profitable market because the underlying incremental cost to add such features to an account is trivial, while the relative retail price is high. To the reseller, however, serving such customers causes the reseller to incur higher costs, because the cost to a reseller to add a feature to a customer's line is the relatively high retail price of the feature (reduced by the wholesale discount), and not the much lower incremental cost enjoyed by the incumbent. To the reseller, there are no "cherries to pick," which are so critical to competitive success.[7]

* Finally, the methodology used to establish the wholesale discount – *i.e.*, removing from the incumbent's retail price an estimate of the incumbent's marketing and customer support costs – does not generally provide a margin large enough to attract and sustain entry. These discounts were typically set shortly after the Act was enacted, at a time when the incumbent's marketing costs reflected its monopoly status. As a monopoly (or near-monopoly), the incumbent only incurred marketing costs to increase its revenues through incremental sales. In contrast, an entrant incurs the much *higher* marketing costs needed to win customers from the incumbent. Combined with the advantages of its economies of scale,[8] the conflicting marketing imperatives of an incumbent monopoly and the entrant effectively assure that any discount derived from the costs an incumbent avoids would be insufficient to cover the costs an entrant would incur.

Third, resale only makes the entrant a "half-a-carrier," because it does not permit the entrant to provide access services to its customers. In the resale scenario, the reseller continues to share each of its customers with the incumbent, because the incumbent retains the lucrative access portion of the product mix for each of the resellers' customers.[9] This fact – *i.e.*, that the incumbent remains the access provider to the

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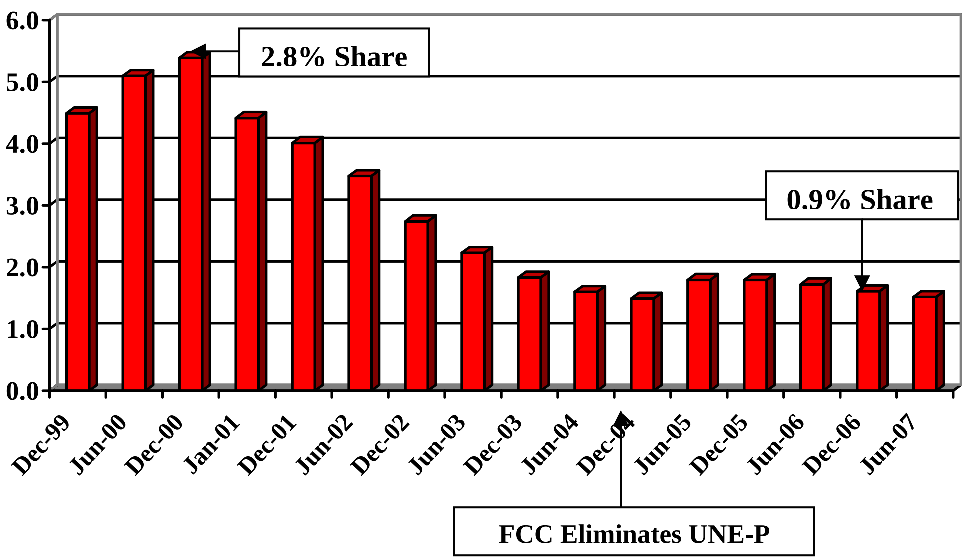
[7] In any market with an established incumbent – and, in telecommunications, the incumbent not only enjoys a 100-year head start, but decades of government protection from competition – the natural progression of entry is to first compete for high-value customers, then extend service to other customers over time. With resale, the across-the-board discount from the incumbent's retail rate means there are no high-value customers to support initial entry.

[8] Like most commercial activities, marketing and customer support are likely to enjoy scale economies. That is, the larger the base of subscribers, the lower the per-unit cost. As such, the cost avoided by an incumbent (essentially serving the entire market) for marketing and customer care is likely to be smaller (per unit) than the cost that would be incurred by an entrant serving a small fraction of the market. Moreover, even if both faced the same marketing *problem* (which, as explained above, they do not), the cost structure of the entrant would likely be higher (particularly as it first enters a market) than the cost enjoyed by the incumbent.

[9] In simple terms, local exchange carriers offer two products (and enjoy two revenue streams) over the same facility: (a) the retail service offered the end user to attract it to the

resellers' customers – has two impacts. The first is that an important revenue stream (carrier access charges) is denied the reseller, who must cover all of its costs solely through retail revenues. Second, and perhaps more importantly, the reseller must continue to pay *usage*-based access charges to the incumbent, even to provide toll services to its own retail customers. This usage-sensitive cost structure effectively prevents the reseller from offering the flat-rated bundles of local and long distance calling so popular with consumers and many businesses.

Figure 1: National Resale Trends
(millions of lines)



Given the structural disadvantages described above, it not surprising that resale has never played a significant role in the market. As shown in Figure 1, even at its zenith – now more than eight years ago – its nationwide market penetration was only 2.8%. Today, that penetration has fallen to less than 1% and is continuing to decline. The sole exception to this continuous decay was immediately after the FCC eliminated UNE-P in the *Triennial Review Remand Order*.[10] Although this decision caused a temporary increase in resale lines, the trend immediately began to decay again and has continued downward ever since.[11]

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carriers' network; and (b) the access service sold to other carriers, to originate and, more importantly, terminate long distance calls to those subscribers.

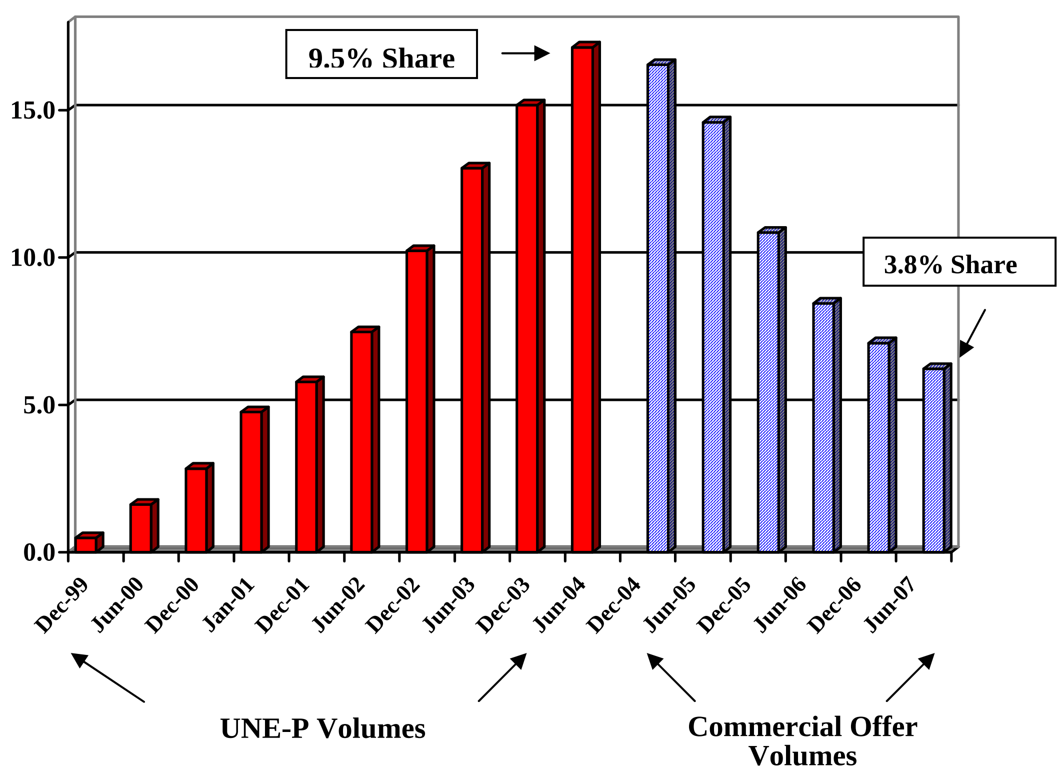
10 *Unbundled Access to Network Elements*; *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, Order on Remand, 20 FCC Rcd 2533 (2005) ("*TRRO*"), *affirmed Covad Communications v. FCC*, 450 F.3d 528 (D.C. Cir. 2006).

11 It is telling that the FCC's pricing rules applicable to resale, which had been challenged by the RBOCs, were *vacated* and remanded by the Eighth Circuit in July 2000 and the FCC has never adopted a replacement. Obviously, if the resale option was negatively affecting the incumbents in a material way, the incumbents would have asked the FCC to translate their

<u>The Declining Significance of RBOC Commercial Offers</u>

In contrast to resale, the unbundled network element platform (UNE-P) – which was priced at cost-based rates pursuant to Section 252(d) and the FCC's TELRIC pricing standard – initially succeeded at supporting mass market competition, in large part because it was not hampered by any of the structural deficiencies of resale. Because UNE-P enabled entrants to lease a generic loop, switching and transport platform at cost-based rates established by a neutral arbiter (the state commission), the strategy allowed the CLEC to set the rates, terms and conditions of its offering wholly independent of the ILEC's retail pricing in the market. Moreover, the cost-based rates enabled an entrant to enjoy the same basic cost structure as the incumbent, allowing the competitor to innovate by offering service packages that *differed* from those of the incumbent, including the all-important flat-rate packages of local and long distance service that transformed the

Figure 2: National UNE-P/Commercial Offer Trends
(millions of lines)



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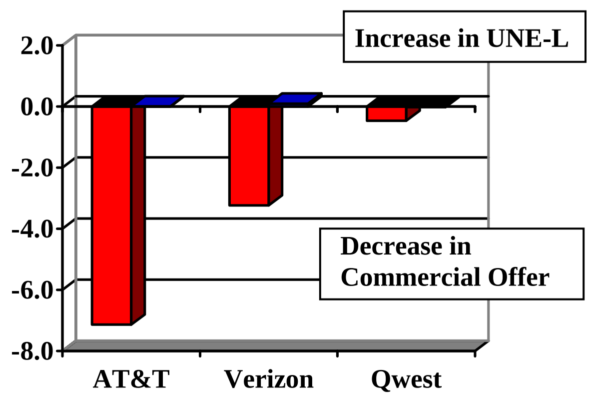
appellate victory into new pricing rules that would produce a lower discount. Resale is so competitively irrelevant, however, there has been no effort to have new rules adopted or lower discounts approved.

market.[12] When UNE-P was priced at cost-based rates established by the *regulator*, the option could constrain the market power of the incumbent; once the prices were established by the *incumbent*, however, that role has disappeared.

The FCC's *Triennial Review Remand Order* effected a fundamental change in the economic attractiveness and stability of UNE-P, replacing this important wholesale arrangement with Commercial Offers unilaterally priced by the incumbent RBOC without – for all practical purposes – regulatory oversight.[13] For consumers, this means that the CLEC's cost structure is no longer independent of the RBOC's pricing decisions for its own telecommunications services. As the RBOC increases the price of its end user services, the RBOC can also increase the prices for its Commercial Offers so as to support its price increases. Furthermore, RBOCs can price Commercial Offers to eliminate CLECs from more attractive market segments. Thus, unlike a CLEC using UNE-P, the CLEC using RBOC Commercial Offers is unlikely to be able to discipline ILEC attempts to exercise market power by raising prices. As a result, the RBOC Commercial Offers have replaced the competitive promise of UNE-P with widespread market exit. Because the consequence of imposing a high price on the CLEC is higher revenues to the RBOC until the CLEC exits, the RBOCs have no incentive to offer a reasonable wholesale price.[14]

Figure 3
Comparing Increase in UNE-L to Decline in Commercial Offer Lines
(Dec. 2004 to Jun. 2007)



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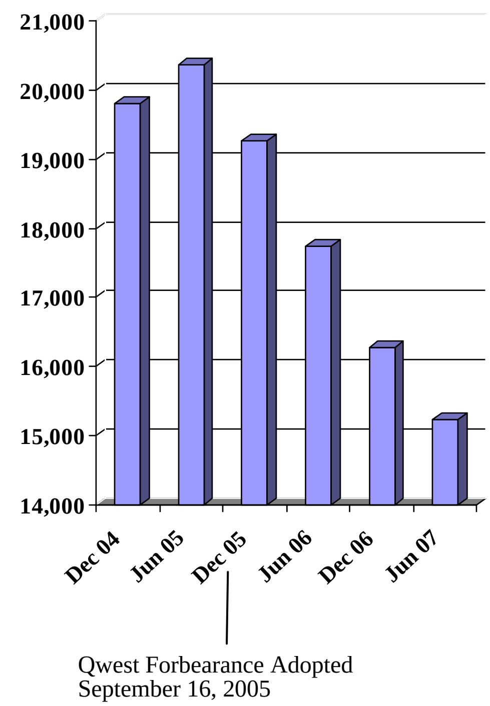
[12] Although similar packages are today offered by incumbents, the incumbents first introduced such packages as a competitive response to the innovative offerings of UNE-P based carriers such as Z-Tel Communications and MCI.

[13] It is not the purpose of this analysis to describe in detail the competing theories concerning whether the RBOCs' commercial offers satisfy their ongoing Section 271(c)(2)(B) obligation to offer competitors access to unbundled loops, transport, and switching, whether these Section 271 elements meet the "just and reasonable" rate standard of Section 201, or whether there is a legitimate State role arbitrating the rates for Section 271 offerings. Although these issues are not yet settled, the courts have thus far determined that the FCC has exclusive jurisdiction to review Section 271 rate issues, and the FCC has provided no further guidance to the industry. The purpose of this analysis is not to develop or resolve these questions, but to emphasize that as a result of the ambiguity surrounding these issues, the RBOCs are not today regulated in the prices they charge for the so-called Commercial Offerings that contain these Section 271 elements.

[14] Before the courts began limiting State authority to review RBOC pricing of alternatives to UNE-P, a number of States had reviewed whether the prices imposed by the RBOCs in such commercial agreements were just and reasonable. Significantly, not a single State that has

Importantly, the rapid decline in UNE-P (now Commercial Offer) lines is not validation of the predictive judgment in the *TRRO* that carriers would shift such lines to their own switches or switching provided by another carrier. If that predictive judgment were correct, the decline in UNE-P/Commercial Offer lines would be offset by an increase in UNE loops.[15] To the contrary, as shown in Figure 3, the loss in UNE-P lines has *not* been accompanied by any material increase in UNE-L lines.[16] The predictive judgment that the elimination of UNE-P would be offset by a shift in these lines to UNE-L has been shown to be wrong.

Figure 4: Effect of Omaha Experiment on UNE-Loop Competition - Nebraska



The core problem exposed by Figure 3 – that is, the absence of regulatory oversight does not lead to reasonable wholesale offerings that are priced independently from the ILEC's own retail pricing decisions and that support competition – is not limited to the mass market and the inadequacy of the RBOCs' Commercial Offers. A similar result occurred in the Omaha market following the FCC's predictive judgment that Qwest would continue to offer meaningful wholesale services after Qwest's legal obligation to offer unbundled loops and transport at cost-based rates was removed through forbearance.[17]

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reviewed these prices has ever concluded that the prices imposed by the RBOCs were just and reasonable.

15 Any carrier capable of completely bypassing the incumbent through its own loop facilities (such as, for instance, a cable-based entrant) would not likely have *ever* relied upon UNE-P (at least within its loop footprint). Consequently, there is no reason to believe that CLECs are substituting their own loop facilities for UNE-P lines to any significant decree.

16 It should be noted that the comparison in Figure 3 overstates the level of substitution between UNE-L and UNE-P because the decline in UNE-P lines consists almost entirely of analog facilities serving traditional POTS customers, while the vast majority of UNE-L facilities leased by CLECs are high-speed digital facilities used to provide more complex services in the business market. If the analysis compared the decline in UNE-P lines to the offsetting increase in *analog* UNE loops, the imbalance and decline in CLEC activity would be even greater.

17 *See* Petition of Qwest Corporation for Forbearance Pursuant to 47 U.S.C. § 160(c) in the Omaha Metropolitan Statistical Area, WC Docket No. 04-223, Memorandum Opinion and Order, 20 FCC Rcd 19415 (2005) ("*Omaha Forbearance Order*"), *aff'd Qwest Corporation v. Federal*

Figure 4 demonstrates that the effect of the Omaha forbearance decision has been a collapse in wholesale volume, as Qwest increased rates between 30% (individual DS0s) and 178% (DS3s).[18] These price increases caused a significant decline in competitive activity, with UNE loop volumes declining by 25% for the entire State of Nebraska.[19]

The Omaha Experiment reinforces the conclusion drawn from the broader Commercial Offer analysis above – that is, when the RBOC is permitted to set the price of its wholesale offerings without oversight, those wholesale offerings do not support retail competition and cannot constrain the retail pricing of the incumbent.

Conclusion

The evidence concerning resale and the Commercial Offers of the RBOCs provide further evidence that these carriers enjoy substantial market power, particularly for wholesale services. Because the pricing of such arrangements protects the retail pricing strategy of the RBOC, no competitive weight should be attributed to resale and Commercial Offer lines in any analysis of RBOC market power.

Communications Commission, Case No. 05-1450, (D.C. Cir. Mar. 23, 2007). Specifically, the FCC predicted that competition from the facilities of Cox (the cable-based provider of telephony services in the Omaha market), as well as Qwest's continuing obligations under Section 271, would keep wholesale rates at just and reasonable levels and thereby protect retail competition. *See Omaha Forbearance Order*, at ¶¶ 66, 79.

[18] *See* Letter to Marlene H. Dortch, Secretary, Federal Communications Commission, from William Haas, McLeodUSA, WC Docket No. 04-223 (filed Nov. 17, 2007) ("*McLeodUSA Ex Parte*"). McLeodUSA further explained in this filing that it intends to exit the Omaha market if the FCC does not reverse its forbearance experiment.

[19] Data limited to the Omaha market is not publicly available.