

April 23, 2010

VIA ECFS

EX PARTE

Ms. Marlene H. Dortch
Secretary
Federal Communications Commission
Room TW-325
445 12th Street, S.W.
Washington D.C. 20554

RE: WC Docket No. 05-25

Dear Ms. Dortch:

Yesterday, the undersigned and Jonathan Lechter of Willkie Farr & Gallagher LLP, representing tw telecom inc. (“TWTC”), Don Shephard of TWTC, Russell M. Blau of Bingham McCutchen LLP, representing PAETEC Holding Corp., Thomas Cohen of Kelley Drye & Warren LLP, representing XO Communications, LLC (“XO”) and Lisa Youngers of XO met with Sharon Gillett, Donald Stockdale, Nicholas Alexander, Albert Lewis, Jennifer Prime and Marcus Maher of the Wireline Competition Bureau regarding matters related to special access.

The attached presentation formed the basis of the discussion.

Pursuant to Section 1.1206(b) of the Commission’s rules, a copy of this notice is being filed electronically in the above-referenced proceeding. Please contact me if you have any questions.

**PRESENTATION REGARDING INTERIM STEPS
TO REGULATE UNREASONABLE DS1/DS3 SPECIAL ACCESS PRICES
WC Docket No. 05-25
(April 22, 2010)**

I. THE CURRENT REGULATORY FRAMEWORK HAS ENABLED ILECS TO CHARGE UNREASONABLE DS1 AND DS3 SPECIAL ACCESS PRICES IN PHASE II AREAS

The Pricing Flexibility Triggers Are Flawed. The pricing flexibility triggers do not predict where competition would be sufficient to constrain ILEC market power. Among other things, the triggers (1) permit an ILEC to obtain pricing flexibility for loops without showing that any competitors have deployed their own loops; (2) rely on collocations when numerous collocated carriers provide service when relying on ILEC facilities yet deploy no loops and transport of their own because it is uneconomical to do so at low capacities; (3) potentially provide relief for channel terminations and transport based on the presence of a *single* fiber-based collocater in a particular percentage of wire centers or in wire centers representing a particular percentage of revenue; (4) provide relief throughout an MSA even though competitive deployment is likely present in only a small portion of the MSA. Indeed, the inaccuracy of the trigger test was underscored by the GAO, which found that there were more competitor lit buildings in MSAs that remained under price caps than those which were granted Phase II pricing flexibility.¹

Competitors Are Unable to Economically Deploy Facilities to Provide DS1 and DS3 Services. The substantial evidence in the record indicates that the competitors can rarely generate sufficient revenue to construct facilities to provide DS1 and DS3 services even to buildings which are close to their fiber networks.² To the extent competitors deploy DS1s and

¹ See GAO, *FCC Needs to Improve Its Ability to Monitor and Determine the Extent of Competition in Dedicated Access Services*, GAO-07-80, at 12-13 (Nov. 2006) (“*GAO Report*”) (“The data also show that the theoretically more competitive phase II areas generally have a lower percentage of lit buildings than phase I areas, indicating that FCC’s competitive triggers may not accurately predict competition at the building level.”).

² See, e.g., Letter of Thomas Jones, Counsel, tw telecom, to Marlene H. Dortch, Secretary, FCC WC Dkt. No. 05-25, at 13 (filed July 9, 2009) (“*TWTC July 9, 2009 Letter*”) (“[I]n the *TRO*..., based on incumbent LEC and CLEC data, [the FCC found] that it was almost always uneconomical for competitive carriers to deploy DS1 and DS3 loop facilities.”); see also Sprint Nextel *Ex Parte* Presentation, *Special Access Pricing*, WC Dkt. No. 05-25, at n.89 (filed Oct. 5, 2007) (“*Sprint Oct. 5, 2007 Ex Parte*”); Comments of Covad *et al.*, WC Dkt. No. 05-25, RM-10593 (“*Covad et al. Comments*”), Declaration of Ajay Govil on Behalf of XO, ¶¶ 19, 27 (stating that XO will not construct facilities unless the capacity demand is at least three DS-3s, and that interoffice transport routes are only justified with at least nine to twelve DS-3s of traffic (filed Aug. 8, 2007); Comments of ATX Communications, Inc., *et al.*, WC Dkt. No. 05-25, RM-10593, Attach. 1: Declaration of Don Eben, ¶ 4 (stating that it is “rarely economically feasible” to build last mile connections at DS0, DS1 or DS3 levels to individual customer premises) (filed Aug. 8, 2007).

DS3s to a particular location, they are able to do so only because the aggregate demand (of multiple DS3s) at that location is sufficient to justify construction.³

ILEC Phase II Rates Are Higher Than Price Cap Rates In Nearly Every Case. Since ILECs have been granted pricing flexibility, ILECs initially increased Phase II area rates for both channel terminations and transport above price cap area rates, and the ILECs have sustained that differential in nearly every instance for nearly every element. This is true for services under both month-to-month tariffs as well as services under volume and term tariffs.⁴ The logical conclusion is that the ILECs are exercising their market power in Phase II areas.

The incumbents' assert, without basis, that price cap rates are set below competitive levels and Phase II rates are the "true" competitive level.⁵ If the ILECs truly believed that they were under-earning on a wide scale in price cap areas, they would not have advocated eliminating the accounting rules which, by their own admission, would have been the primary way in which they would have been able to present a case to the FCC for under-earning.⁶ At a minimum, they

³ *Unbundled Access to Network Elements; Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, Order on Remand, 20 FCC Rcd 2533, ¶ 154 (2004) ("TRRO") ("[T]he record indicates that carriers can sometimes economically serve lower-capacity customers (e.g., customers at the DS1 capacity level) in multi-tenant buildings because the incremental costs of providing channelized capacity over a higher-capacity fiber loops are minimal when one or more other customers in a building are already served by competitive fiber of sufficient capacity.").

⁴ See, e.g., *TWTC July 9, 2009 Letter*, Attach. A: *Pricing Charts and Methodology for Pricing Charts* (comparing RBOC Phase II and price cap rates under one year, no volume plans to UNE rates and competitors' one year, no volume commitment prices); see also *TDM Price Charts*, attached to Letter of Thomas Jones, Counsel, TWTC, to Marlene H. Dortch, Secretary, FCC, WC Dkt. No. 05-25 (filed Oct. 11, 2007) (comparing RBOC Phase II and price cap rates under substantial volume/term discounts to UNE rates and competitors' one year, no volume commitment prices); *GAO Report* at 28 ("Our comparison of 1,152 prices found that, as of June 2006, the price-flex list price was on average higher than the price-cap price, regardless of whether the price was for channel terminations, interoffice mileage, DS-1 or DS-3 service, different term arrangements, or different density zones.").

⁵ See, e.g., Qwest Comments, WC Dkt. No. 05-25, RM-10593, Declaration of Timothy J. Tardiff & Dennis L. Weisman ¶ 27 (filed Jan. 19, 2010) ("*Tardiff-Weisman Declaration*"); Verizon & Verizon Wireless Reply Comments, WC Dkt. No. 05-25, RM-10593, Attach A: Reply Declaration of Michael D. Topper ¶ 20 (filed Mar. 19, 2010) ("As a matter of economics, comparisons of rates in price-flex and price-cap regions are not informative and cannot support a conclusion that price-flex prices are supracompetitive, unless one first assumes that price-cap rates are at or above the price level that would emerge in a competitive market setting.").

⁶ See *Petition of AT&T Inc. For Forbearance Under 47 U.S.C. § 160 From Enforcement of Certain of the Commission's Cost Assignment Rules*, Memorandum Opinion and Order, 23 FCC

would have argued in this proceeding that the current price cap levels are costing them billions of dollars that they would have earned if price caps were set at the “correct” level. They have not done so.

ILEC Phase II Rates Are Well In Excess of Their Costs. ILEC Phase II prices are well above UNE rates (which exceed forward-looking costs) in nearly every instance, in many cases more than twice as high, demonstrating that the incumbents are earning returns well above their costs.⁷ In addition, over the past 10 years, ILECs’ ARMIS returns have been well in excess of any reasonable level. The composite RBOC ARMIS rate of return reached 101 percent in 2007.⁸ As Ad Hoc has recently explained in detail, ARMIS data continue to be a valid way to measure the incumbents’ profit levels and provide ample evidence that special access rates, particularly the higher rates in the Phase II areas are well above the ILECs’ costs.⁹

ILEC Phase II Rates Are Well In Excess of Competitors’ Prices. Substantial evidence entered into the record demonstrates that incumbent Phase II special access rates (both for channel terminations and transport) are well above competitors’ rates for similar terms and conditions in the incumbents’ “least expensive” zone 1 areas. In many cases, the incumbents’ prices are twice as high as competitors’ for the same element.¹⁰ Charts submitted by TWTC

Rcd 7302, ¶ 19 (2008) (“Because these changes have eliminated ongoing tinkering with price caps, we no longer routinely need the accounting data derived from the Cost Assignment Rules for rate regulation functions.”). In support of that assertion, the FCC cited to AT&T’s reply comments where AT&T admitted that “a price cap ILEC raising a confiscation claim may find it more difficult to prove such a claim without separated cost data.” *Id* at n.71 (*citing* AT&T Reply Comments, WC Dkt. No. 07-21, at 17 (filed Apr. 9, 2007)).

⁷ *See, e.g., Covad et al. Comments* at 17 (“In the states analyzed, the month-to-month recurring price cap rates (no term commitment) for DS1 loops/channel terminations are vastly higher than the UNE DS1 rates, ranging from 67% higher in Arizona to 802% higher in Illinois. The month-to-month recurring Phase II pricing flexibility rates are all at least 100% higher than UNE DS1 loop rates, with many of the state Phase II rates 200-300% higher than the cost-based UNE rates. Significantly, in all but one state surveyed, the Phase II pricing flexibility rates were also higher than the regulated price cap rates in the highest density zone in the state.”); *see also id.*, Attach. 2 (charts illustrating these data).

⁸ *See* Comments of Ad Hoc Telecommunications Users’ Committee, WC Dkt. No. 05-25, RM-10593, Attach. B: Susan Gately *et al.*, *Longstanding Regulatory Tools Confirm BOC Market Power: A Defense of ARMIS* at ii (filed Jan. 19, 2010).

⁹ *See generally, id.*

¹⁰ *See, e.g.,* Global Crossing Comments, WC Dkt. No. 05-25, RM-10593, Declaration of Janet Fischer, ¶ 6 (filed Aug. 8, 2007) (comparing special access prices under both price caps and price flex with prices offered to Global Crossing by 4 alternative providers, and finding that “price cap and pricing flexibility rates are typically two to three times higher than competitive carriers, and

showed that incumbents' Phase II rates under multiple year volume/term agreements were still higher than one year, no volume competitors' rates in almost every instance.¹¹

ILECs try to explain this differential by arguing that they have higher costs than CLECs. But it is unlikely that incumbents' costs are higher (particularly with respect to DS1s and DS3s in zone 1 areas) for at least three reasons: (1) ILECs provide DS1s and DS3s primarily via copper facilities which have long been depreciated (not the case with competitors); (2) ILECs' economies of scale and scope are greater than competitors'; and (3) ILECs' relatively higher cost of providing service in outlying areas should not impact their costs in the lower cost urban cores and office parks where competitors provide service because ILECs can disaggregate special access prices by up to seven zones per study area.

ILECs' Special Access Market Share Has Remained Stable Over Time, Demonstrating ILEC Dominance. The ILECs argue that high market share does not demonstrate market power because market share calculations do not capture potential future entry.¹² But special access market share over the past 10 years has been remarkably stable, with ILECs in a dominant position, indicating enduring barriers to entry.

Over the past 10 years, competitors, independent third parties (e.g., the GAO and DOJ), and the FCC itself have all concluded that ILECs have a dominant share of both last-mile facilities as well as DS1 and DS3 services provided over carriers' own facilities (i.e. Type I services).¹³ Nearly every measure of ILECs' share of the Type 1 DS3 market is consistently above 80 percent and ILECs' share of the Type 1 DS1 market is consistently above 90 percent.¹⁴ Given the enduring barriers to entry, there is no reason to believe this will change.

the pricing flexibility price is higher than the price cap for the same facility."); *see also id.*, Tables 5 & 6 (charts illustrating these data).

¹¹ *See, e.g., TWTC Pricing Charts, supra* note 4.

¹² *See, e.g., Tardiff-Weisman Declaration* ¶ 38; Verizon Comments, WC Dkt. No. 05-25, RM - 0593 at 17, 29-30 (filed Jan. 19, 2010) ("*Verizon Comments*").

¹³ *See, e.g., GAO Report* at 12 ("In the 16 major metropolitan areas we examined, facilities-based competition for dedicated access services exists in a relatively small subset of buildings. Our analysis of data on the presence of competitors in commercial buildings suggests that competitors are serving, on average, less than 6 percent of the buildings with at least a DS-1 level of demand."). The DOJ concluded that Verizon controlled the only last-mile access to the "vast majority of commercial buildings in its territory," *United States v. Verizon Communications, Inc. and MCI Inc.*, Case No. 1:05CV02103, Complaint ¶ 15 (D.D.C. filed Oct. 27, 2005) ("*DOJ Complaint*"); *GAO Report* at 25 ("[The] DOJ found [in its review of the Bell/IXC mergers] that, for the vast majority of buildings in the MSAs it reviewed, no competitive providers of dedicated access facilities existed[.]").

¹⁴ *See, e.g., Sprint Oct. 5, 2007 Ex Parte*, at 63 ("[I]n Phase II areas, 97.2% of all Sprint Nextel's DS1s and 88.6% of all Sprint Nextel's DS3s were purchased from the incumbent LEC. These

While some competitors have slowly constructed loops to commercial buildings, the market share data show that competitor-owned loops continue to represent a tiny fraction of the total market. At the same time, demand for ILEC special access and ILEC special access output have been consistently increasing over the last 10 years, indicating that ILEC share of the special access market has, if anything, increased over time.¹⁵

The Direction of the ILECs' Average Price Per Unit For Special Access Over Time Has No Bearing On Whether ILECs Are Exercising Market Power. The incumbents make much of the fact that their average price per DS1 and DS3 has declined over time.¹⁶ As an initial matter, much of this price decline may be attributable to price cap induced reductions and demand shifts to longer term contracts with greater per unit discounts, not any actual reduction in tariffed rates. More importantly, as Dr. Stanley Besen has explained, a decline in a firm's prices, by itself, says nothing about whether that firm is exercising market power to set supra-competitive prices.¹⁷ Rather, incumbents' profit margins are the best measure of the extent to which incumbents have market power.¹⁸ The monopoly price can rise or fall for many reasons. For example, as Dr. Besen explains, a monopolist's price reduction would be consistent with declining marginal cost as output increases.¹⁹ AT&T no doubt understands that the direction of price has no bearing on market power because legacy SBC argued (in response to legacy AT&T's petition for special

reports are echoed by [TWTC], Ad Hoc, and API, among others, and are consistent with the claims AT&T made in its Petition for Rulemaking.”).

¹⁵ See *Verizon Comments* at 8-9 (“The Commission’s own data for large ILECs showed that between 2003 and 2006, special access lines increased by approximately 26.3 percent per year when calculated on a voice-grade equivalent basis. Likewise, between 2006 and 2007...special access lines grew again by 23.1 percent.”); *Verizon Opposition, RM-10593, Declaration of Alfred E. Kahn & William E. Taylor*, at 12 (filed Dec. 2, 2002) (“*Kahn-Taylor Declaration*”) (“These data clearly show a rapid and accelerating growth of RBOC special access lines, averaging 30 percent per year over the 1996-2001 period.”).

¹⁶ See, e.g., *AT&T Comments, WC Dkt. No. 05-25, RM-10593*, at 25 (Jan. 19, 2010) (“*AT&T Comments*”); *Verizon Comments* at 6-8.

¹⁷ See *TWTC July 9, 2009 Letter, Attach B: Declaration of Stanley M. Besen* ¶¶ 3-4.

¹⁸ See *id.* ¶ 5 (“[T]he difference between a competitive and monopolistic industry is not the direction of, or rate at which, their respective prices *change* during a given period but the fact that a monopolist charges a *higher* price relative to its marginal cost than does a competitive firm.”) (emphasis in original).

¹⁹ See *id.* at n.14 (“An increase in demand could result either in an increase in price, if marginal cost increases with output, or a decrease in price, if marginal cost declines as output increases.”).

access rulemaking and allegations of rising special access rates) that special access price *increases* were not evidence of the exercise of market power.²⁰

Intermodal Competition From Hybrid Fiber Coax (HFC) Cable Modem Service and Fixed Wireless Networks Is Not Restraining ILEC Market Power. The FCC has found that cable company HFC facilities, which are only capable of providing best-effort, typically asymmetrical services, are not a viable substitute for wireline DS1s and DS3s.²¹ ILECs themselves now argue that the asymmetrical HFC-based cable modem service and special access services do not occupy the same market because of their different service attributes and wide differences in price.²² Competitors have long argued that this is the case.²³ To the extent that cable companies deploy last-mile fiber facilities to provide DS1 and DS3 services, they face similar barriers as “traditional” CLECs.

Nor is fixed wireless a viable substitute for special access beyond rural areas where line-of-sight issues are minimal and there are few wireline competitors available.²⁴ Indeed, Verizon’s panelist

²⁰ See Opposition of SBC Communications Inc., RM -10593, Attach A: *Kahn-Taylor Declaration*, at 14 (filed Dec. 2, 2002) (“[A]n increase in prices, revenue and demand volumes is not necessarily evidence that a large firm possesses market power[.]”).

²¹ See *TRRO* ¶ 193 (“Commenters also note that businesses that do require DS1 loops are willing to pay significantly more for them than the cost of a cable modem connection, which also indicates that the two are not interchangeable.”).

²² See *AT&T Comments*, Exh. A: Declaration of Dennis W. Carlton & Hal S. Sider, ¶¶ 23-25.

²³ See, e.g., *Covad et al. Comments* at 25 (“Where cable television networks reach business customers, they generally lack the capacity to serve large number of business customers that require telecommunications and Internet services at DS1 and higher speeds. While some cable networks have been developed to provide high bursts of speeds to smaller customers, few cable systems are capable of meeting the high bandwidth requirements of larger customers like those serviced by XO, Covad, and NuVox.”); Workshop Response of tw telecom *et al.*, GN Dkt. No. 09-51, WC Dkt. Nos. 07-245 *et al.*, CC Dkt. No. 98-147, at 6 (filed Sept. 15, 2009) (“Most business customers also demand reliable and stable bandwidth speeds. One workshop panelist asserted that even a next-generation DOCSIS 3.0 cable modem system cannot provide stable and reliable bandwidth because bandwidth is shared near the edge of the network at a local node.”).

²⁴ See Statement of Ed Evans, Chairman and CEO, Stelera Wireless, National Broadband Workshop: Deployment Wireless - General, Transcript at 39-40 (Aug. 12, 2009) (“[W]hile DSL is prevalent in a lot of rural markets, I mean, candidly, there’s a lot of bad DSL that’s out there....As you get farther and farther away from that central office, we’ve seen DSL speeds that cap out at 256k [and] it’s been very easy to cherry pick those guys off the edge of their network until you get closer to their CO where, you know, their speeds are closer to [1.5 Mbps].”), available at http://www.broadband.gov/ws_deployment_wireless.html. Said another wireless provider “I would definitely agree. You know, in our markets, we don’t try and compete with DSL and cable. I mean, quite frankly, we can’t do that. You know, we can’t deliver what they

at the broadband workshops observed that Verizon's LTE and WiMax technologies are a complement to, not substitute for, wireline broadband service.²⁵

This is not to say that *no* business customers view HFC-based and fixed wireless services as substitutes for special access service. Rather, the relevant inquiry is whether a *sufficient number* of customers would shift to HFC-based or wireless services to prevent incumbents from imposing a price increase on special access service. There is no reason to believe this is the case.

II. THE FCC SHOULD TAKE THE FIRST STEP TOWARD ADDRESSING THE HARM CAUSED BY ITS FLAWED REGULATORY REGIME BEFORE AT&T'S RATE INCREASE TAKES EFFECT

AT&T's Imminent Price Increase, Planned By AT&T Three Years In Advance, Should Trigger FCC Action. AT&T's extraordinary ability to plan a price increase three years in advance for DS1 and DS3 special access provides clear evidence of its unilateral pricing power.²⁶ The FCC should act promptly to avoid this outcome and to remedy the most obvious consequences of the flawed regime for DS1 and DS3 special access.

The FCC Should Immediately Reduce All Phase II Rates To Price Cap Levels and Refuse to Grant Any Further Petitions for Pricing Flexibility. Given the overwhelming evidence described above that the current pricing flexibility triggers do not accurately assess where competitive deployment is sufficient to restrain incumbent market power and that incumbents are

can deliver, but, again, in our rural areas, we go where DSL and cable aren't." Statement of Scott Zimmer, President, Air Advantage, National Broadband Plan Workshop: Deployment Wireless - General, Transcript at 41 (Aug. 12, 2009), *available at* http://www.broadband.gov/ws_deployment_wireless.html.

²⁵ See Statement of Tom Sawanobori, Vice President, Network and Technology Strategy, Verizon, National Broadband Workshop: Deployment Wireless - General, Transcript at 17, 51-52 (Aug. 12, 2009), *available at* http://www.broadband.gov/ws_deployment_wireless.html.

²⁶ See, e.g., Ameritech Services, Tariff FCC No. 2, Description and Justification, Transmittal No. 1617, at 1 (filed May 18, 2007) ("Ameritech proposes language to clarify that temporarily reduced rates for DS1 and DS3 local distribution and/or channel mileage services, filed on Transmittal No. 1605, apply solely to interstate services, and that these reduced rates expire on June 30, 2010. In addition, new rate pages are being introduced for DS1 and DS3 local distribution channel and mileage services that *reflect rates that were in effect on April 4, 2007 and that will be effective again on July 1, 2010.*") (emphasis added); Ameritech Services, Tariff FCC No. 2, Letter of Patrick Doherty, Director, Access Regulatory Affairs, AT&T, to Marlene H. Dortch, Secretary, FCC, Transmittal No. 1605 (filed Mar. 29, 2007) ("With this filing, Ameritech is proposing to introduce rate reductions in areas where the F.C.C. has granted Phase II pricing flexibility for price cap services, which is being filed in compliance with Special Access Merger Commitment #6 of the AT&T/BellSouth Merger... This provision is temporary and will remain in effect until June 30, 2010.").

in fact exercising market power by setting Phase II special access prices well above competitive levels and ILECs' own costs, the FCC should adopt interim measures to rein in unreasonable Phase II prices. Such remedies should extend until the conclusion of this proceeding and should include the following: (1) reducing all special access prices in Phase II areas to the level of prices subject to price caps; and (2) refusing to grant any further pricing flexibility.