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MAY 28 2010

Federal Communications Commission
Office of the Secretary

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

Re: ***In the Matter of Special Access Rates for Price Cap Local Exchange Carriers*, WC Docket No. 05-25**

Dear Ms. Dortch:

On behalf of PAETEC Holding Corp., on behalf of its operating subsidiaries, PAETEC Communications, Inc., US LEC and McLeodUSA Telecommunications Services, Inc. (all doing business as "PAETEC") and XO Communications LLC, please find enclosed two copies of a redacted version of an ex parte letter filed today in the above referenced docket. Pursuant to the protective order in this proceeding[1], two copies of the confidential version of the ex parte letter have been filed with Margaret Dailey and a copy of the confidential version of the ex parte letter has also been filed with the Secretary. An electronic copy of the redacted version of the ex parte letter has also been filed with the Secretary's Office via ECFS.

Please let us know if you have any questions with respect to this submission.

[1] *Special Access Rates for Price Cap Local Exchange Carriers*, Order, 20 FCC Rcd 10160 (2005).

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Respectfully submitted,

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May 28, 2010

VIA ECFS & HAND DELIVERY ***EX PARTE***

Ms. Marlene H. Dortch
Secretary
Federal Communications Commission
Room TW-325
445 12th Street, S.W.
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Re: ***In the Matter of Special Access Rates for Price Cap Local Exchange Carriers*, WC Docket No. 05-25**

Dear Ms. Dortch:

PAETEC Holding Corp., on behalf of its operating subsidiaries, PAETEC Communications, Inc., US LEC and McLeodUSA Telecommunications Services, Inc. (all doing business as "PAETEC") and XO Communications LLC ("XO") write this letter to urge the FCC to take immediate interim steps to diminish the substantial and recurring harm caused by its flawed special access regime by (1) equalizing Phase II and price cap rates and (2) declining to approve further incumbent LEC petitions for Phase II pricing flexibility. The Commission should retain these interim protections until the adoption of comprehensive reform of the special access regime.

The need for immediate interim action could not be greater. While every day American businesses and competitive carriers are paying supracompetitive rates to the incumbent LECs for special access, this harm problem is especially acute in the Phase II areas where the FCC has inappropriately eliminated price cap regulation. The imminent expiration on June 30th of the AT&T/BellSouth Merger Condition 6 equalizing price cap and Phase II rates in the AT&T territory magnifies this problem. As a result of the expiration of Condition 6, AT&T's customers will pay approximately an extra $125 million or more per year as AT&T's Phase II rates are reset to above price cap levels in nearly every instance.[1] At the same time, Qwest and Verizon, neither of which is subject to Condition 6, have set their Phase II rates above their price cap rates in the vast majority of cases, thereby exacting tens of millions of dollars in excess profits per year from American businesses.

[1] *See* Blair Levin *et al.*, Stifel Nicolaus, *AT&T, FCC Drop Reciprocity from Special Access Cuts, In Win for VZ, Q, at 1* (Mar. 27, 2007) (noting that Commissioner Copps had estimated that the AT&T/BellSouth Merger Condition 6 would "provide about $500 million in total savings to competitors" over the original 48-month term of the condition).

There is no reason for the FCC to wait to obtain further information from the industry to take the limited, interim steps proposed here. The data already filed in the record amply demonstrates that the existing pricing flexibility regime enables incumbent LECs to exercise market power in the provision of special access in Phase II areas. Specifically, the record shows that: (1) the pricing flexibility triggers are fatally flawed; (2) incumbent LECs have market power in the provision of DS1 and DS3 services, as illustrated, for example, by their ability to maintain, over a long period of time, an extremely high market share in the provision of Type I DS1 and DS3 services and the facilities necessary to provide such services; (3) incumbent LEC rates for DS1 and DS3 services in Phase II areas are, in nearly every instance, higher than the prices they charge for the same services in areas subject to price cap rates, and those prices far exceed competitors' rates and incumbent LECs' forward looking costs, thereby further demonstrating that the incumbents possess market power and that they are exercising that market power in Phase II areas; and (4) neither cable companies' HFC-based services nor wireless services constitutes a viable alternative for special access in the vast majority of instances.

It is important to emphasize that the relief sought addresses, on an interim basis, just one of many problems with the existing special access regulatory regime, and it in no way obviates the need for the Commission to undertake comprehensive reform of special access. In particular, the Commission must identify the specific product and geographic markets in which incumbent LECs have market power, and it should adopt long-term rate regulation that is targeted accordingly. That regulation should include lowering the price cap index for the special access price cap basket and applying price cap regulation to special access Ethernet services in product and geographic markets in which the incumbent LECs possess substantial and persisting market power over the facilities needed to provide those services. The joint signatories to this letter have been active and cooperative participants in the Commission's effort to design the long-term solution for Ethernet and TDM special access. We urge the Commission to conduct its comprehensive review of the special access market and to adopt long term, comprehensive reform as quickly as possible. At the same time, however, it is clear that the current regime has yielded an especially severe problem for customers of incumbent LEC DS1 and DS3 special access services in Phase II areas. The FCC should therefore "slow the bleeding" immediately by adopting interim measures ensuring that price cap incumbent LECs cannot set their Phase II prices above price cap levels.

Finally, there is little potential downside to adopting the relief sought here. The incumbent LECs have long argued, contrary to the facts in the record, that their prices for DS1 and DS3 service are disciplined by existing and potential competition. If such competition exists, the incumbents would surely have set their DS1 and DS3 prices at or below price cap levels.[2] Where this is true, the relief sought herein would have no effect at all. The interim proposal sought here would only apply to MSAs in which incumbents set their DS1 or DS3 rates above the levels that would have applied had price caps been retained. Moreover, given the obvious flaws with the price cap triggers and the incumbents' widespread abuse of their pricing flexibility in Phase II areas, the Commission has ample basis for refusing to grant any future request for Phase II pricing flexibility for DS1 or DS3 services.

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[2] As explained below, there is no merit to the incumbent LECs' argument that price caps force incumbent LEC rates below their costs or competitive levels.

I. The Pricing Flexibility Triggers Do Not Accurately Measure The Scope Of Competitive Deployment

Incumbent LECs, independent third parties and competitors all agree that the pricing flexibility triggers are fatally flawed. The triggers (1) permit incumbent LECs to obtain pricing flexibility for channel terminations without any proof that competitors have deployed their own channel terminations;[3] (2) rely on collocations as a measure of facilities-based channel termination competition even though collocators often do not deploy their own channel termination facilities;[4] (3) do not take into account that some competitors that do deploy channel terminations and transport facilities to completely bypass incumbent LEC facilities do not utilize collocation and are therefore not taken into account by the triggers;[5] (4) potentially provide relief for incumbent LEC channel termination and transport service based on the presence of only one fiber-based collocator in a particular percentage of wire centers;[6] (5) provide relief throughout an MSA even if competitive deployment is present in only a small portion of the MSA;[7] (6) do not take into account the inability, in most cases, of competitors to

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[3] *See* PAETEC *et al.* Comments at 13-14 ("[A] price cap ILEC can be granted pricing flexibility for its channel termination rates in an MSA even if no collocator has deployed a single loop in the MSA."). Unless otherwise indicated, all comments referred to herein were filed in WC Dkt. No. 05-25 on or around January 19, 2010.

[4] *See* Sprint Comments at 33 ("[T]he fact that a competitor has collocated facilities in a wire center … does not necessarily indicate that the collocating provider is offering competitive channel termination - or 'last mile' - services out of that wire center or competitive transport along routes desired by existing special access customers."); NoChokePoints Comments at 15 ("[T]he Commission itself has recognized that competitor collocation is a poor proxy for special access competition, especially for competition for channel termination services.").

[5] *See* Verizon & Verizon Wireless ("Verizon") Comments at 20.

[6] *See* PAETEC *et al.* Comments at 15 ("[T]he collocation transport trigger [does not] demonstrate sufficient competition needed to constrain prices as it only requires that 'at least one collocator use competitive transport facilities' 'provided by a transport provider other than the incumbent LEC.'); *see also Unbundled Access to Network Elements; Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers,* Order on Remand, 20 FCC Rcd 2533, ¶ 121 (2005) ("*TRRO*") ("In the absence of other indicia that competitive entry is feasible, the presence of one fiber-based collocator constitutes insufficient evidence of competitors' non-impairment.").

[7] *See* Sprint Comments at 31-33; Massachusetts DTC Comments at 10-12 ("Within such a large area, it is possible for competition to exist in one part of an MSA but is unlikely to constrain ILEC special access pricing in another part of the same MSA."); PAETEC *et al.* Comments at 16 ("[C]ompetition in one part of an MSA will not constrain ILEC special access pricing in another geographic area within the same MSA."); Level 3 Comments at 13 ("Carriers do not compete and offer services by MSAs -- but for knowing where they can/must buy services under pricing flexibility, most carriers would have no reason to know where MSA boundaries begin and end.").

economically deploy lower capacity DS1 and DS3 facilities;[8] and, (7) provide relief for interoffice transport without actually measuring whether competitive transport is available on routes between incumbent LEC offices.[9] In light of these flaws, there is no reason to think that an incumbent LEC that receives Phase II pricing flexibility in an MSA for DS1 or DS3 channel termination or transport services would in fact be subject to significant competition.

Even the FCC recognized this problem to some extent when it adopted the triggers.[10] The FCC nevertheless adopted the triggers based on little more than the hope (without examining and taking into account, as it would in its later unbundling orders, the economic infeasibility of deploying DS1 and DS3 facilities in most cases) that competitors "will eventually extend [their] own facilities to reach [their] customers."[11] This prediction has not been borne out. As the GAO found, there are more competitor lit buildings in MSAs that remain under price caps than those in which Phase II pricing flexibility has been granted.[12] In other words, the FCC's pricing flexibility triggers grant relief without regard to the level of actual competition in an area.

II. The Incumbent LECs Have A Dominant And Stable Share Of the Type 1 DS1 and DS3 Market And The Facilities Necessary To Provide DS1s and DS3s And Barriers To Entry Remain High

Since the initiation of this proceeding in 2002, substantial market share data has been submitted into the record by competitors and third parties (e.g., the Department of Justice and FCC). These data demonstrate that that incumbent LECs have a dominant share of both the physical connections to

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[8] *See infra* discussion at 5-7.

[9] *See* tw telecom inc. ("TWTC") Comments at 20-21 (the presence of a competitive provider of interoffice transport may not result in actual competition or pressure on the incumbent LEC's prices if the competitor has not "collocated its transport facilities in the incumbent LEC central offices in the two wire centers."); PAETEC *et al.* Comments at 15 ("[T]he fact that a collocator may have alternative transport available in two wire centers does not necessarily mean that a competitive alternative route exists between the two ILEC wire centers.").

[10] The FCC acknowledged that the extent of collocations "does not provide direct evidence of sunk investment by competitors in channel terminations between the end office and customer premises." *Access Charge Reform et al.*, Fifth Report and Order and Further Notice of Proposed Rulemaking, 14 FCC Rcd. 14221, ¶ 103 (1999) ("*Pricing Flexibility Order*"), *subsequent history omitted.*

[11] *Pricing Flexibility Order* ¶ 104.

[12] *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.").

customer locations and DS1 and DS3 services provided via such facilities (i.e. Type I services). Indeed, nearly every measure of (1) the physical connections to commercial buildings shows that incumbent LECs control over 90 percent of those connections, (2) the Type 1 DS3 services market shows that incumbent LECs control over 80 percent of that market, and (3) the Type 1 DS1 market shows that incumbent LECs control over 90 percent of that market.[13] The incumbents' high share of these markets has remained stable over time, suggesting high barriers to entry and the presence of market power.[14]

The incumbent LECs have never directly refuted the market share information in the record or provided their own market share estimates. Rather, they seek to downplay the importance of market share to the market power analysis. These arguments are easily dismissed.

First, the incumbents argue that market share is not relevant to the incumbents' ability to sustain supracompetive prices because widespread, facilities-based deployment is just around the corner. The ease with which competitors can and will deploy facilities in the near future, argue the incumbents, restrains the incumbents' ability to set prices at monopoly levels.[15] But the incumbents

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[13] *See, e.g.*, Sprint Nextel Written *Ex Parte*, *Special Access Pricing*, at 63, WC Dkt. No. 05-25 (filed Oct. 5, 2007) ("*Sprint Oct. 5, 2007 Ex Parte Presentation*") ("[I]n 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. These 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."); *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."); *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* Dennis L. Weisman & Timothy J. Tardiff, *Principles of Competition and Regulation for the Design of Telecommunications Policy*, ¶ 11 (filed Oct. 21, 2009), filed on Jan. 25, 2010 as Exh. 3 to Qwest Comments ("*Weisman-Tardiff Paper*") (arguing that the special access market should examined "through a comprehensive understanding of industry trends, technological innovations and *changes in market share over time.*") (emphasis added).

[15] *See, e.g.,* Verizon Reply Comments, WC Dkt. No. 05-25, at 27 (dated Feb. 24, 2010 and filed Mar. 19, 2010) ("Verizon Reply Comments") ("Once competitors have deployed fiber or wireless *networks* in an area, they are able cost effectively to use or extend those networks to serve customers in individual *buildings* where there is sufficient demand. Accordingly, even if a competitor is not yet serving particular buildings, the Commission's forward looking analysis should account for the fact that they readily could do so in many cases....The prospect of such competition provides an additional check on special access rates.") (emphasis in original); Attach. A to Verizon Reply Comments, Declaration of Michael D. Topper, ¶ 7 ("*Topper Reply Decl.*") ("The presence of competing fiber, fixed wireless, or cable providers anywhere within an area of concentrated demand can serve as a source of potential competition that disciplines incumbent pricing conduct throughout the area, even if

have not supported this argument with a demonstration that the barriers to channel termination and transport deployment are low. In fact, there is substantial evidence in the record that it is extremely costly to deploy fiber channel termination and transport facilities. As the FCC recently reiterated, the costs of fiber deployment "range from approximately $11,000 to $24,000 per mile for aerial construction and roughly $25,000 to $165,000 per mile for buried construction."[16] Many competitors have explained that their costs of fiber construction are on the high end of this range.[17] As a consequence of these substantial costs, competitors have explained and the FCC has concluded in its unbundling orders that competitors generally can only build a channel termination to a location if demand at the location exceeds a DS3. To the extent that competitors deploy DS1 and DS3 services to customer locations, they usually only do so if the overall demand at the location is much higher than a DS3.[18] The available market data indicate that there are few locations that meet these criteria.

Moreover, the fact that AT&T has planned a substantial price increase three years in advance for DS1 and DS3 services to coincide with the expiration of Condition 6 further shows that at least

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competitors have not constructed last-mile facilities to a particular building."); Exh. A to AT&T Comments, Declaration of Dennis W. Carlton Hal S. Sider ¶ 63 ("*Carlton-Sider Decl.*") ("CLECs and other special access providers can influence industry price and output even if their current share of lit buildings is small by bidding to provide service in buildings nearby their existing facilities and then extending laterals to those buildings if they win.").

[16] Broadband Availability Gap, FCC, OPI Technical Paper No. 1, at 75 (Apr. 2010) ("*FCC Broadband Cost Report*").

[17] *See, e.g.,* Decl. of Ajay Govil on Behalf of XO ¶ 16 ("*Govil Decl.*"), attached to Covad *et al.* Comments, WC Dkt. No. 05-25 (filed Aug. 8, 2007) ("*Covad et al. 2007 Comments*") ("The average XO building lateral is 500 feet long and on average costs **[confidential begin] [confidential end] [confidential begin] [confidential end]** for the associated electronics, totaling **[confidential begin] [confidential end]** per building assuming no significant space conditioning or internal end user wiring problems.).

[18] *See, e.g., Sprint Oct. 5, 2007 Ex Parte Presentation* at 56 (noting that the Commission agreed that where demand for high-capacity loops 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); Declaration of Michael Clancy on Behalf of Covad ¶ 6, attached to *Covad et al. 2007 Comments* ("*Clancy Decl.*") ("The only environment that provides economic incentive for new investment is when the CAP or CLEC can be assured to acquire a significant economy of scale at a particular address. Demand likely would need to be at or significantly above the three DS3 level at the address for self-supply to be economic."); *Govil Decl.* ¶ 19 ("Due to the extraordinary cost of constructing laterals, XO's current policy is not to consider the addition of a building to its network unless customer demand at that location exceeds at least 3 DS-3s of capacity."); ATX *et al.* Comments, Attach. A: Decl. of Don Eben, WC Dkt. No. 05-25, ¶ 4 (filed Aug. 8, 2007) ("*ATX et al. Aug. 8, 2007 Comments*") ("It is my experience that it is rarely economically feasible for McLeodUSA to build the last -mile connections (*i.e.*, loops) at the DS0, DS1, or DS3 capacity level to individual premises.").

AT&T does not believe that competitive entry will discipline its DS1 and DS3 prices. As soon as AT&T's operating companies filed tariffs reducing their Phase II tariff rates to price cap levels in compliance with the AT&T/BellSouth Merger Order Condition 6, those operating companies added a statement in their tariffs that prices in Phase II areas would rise to pre-merger levels as soon as the condition expired.[19] If AT&T were concerned about the impact of competitive entry, it would not have planned such future price increases.

Second, the incumbent LECs argue that, because they generally offer the same price throughout an MSA, competition in only a limited portion of that MSA prevents the incumbent LECs from exercising market power throughout the MSA.[20] But the existence of an MSA-wide price has no bearing on whether that price is set at supracompetitive levels. As Drs. Mitchell and Woodbury have explained, "in setting a uniform price, the BOC will weigh the profits earned from a higher price on those special access customers across the MSA who continue purchasing at the higher price against the lost profits from those customers who...turn to a CLEC." It follows that, "[t]he larger the special access sales in [the] monopoly area...relative to those in the competitive area..., the higher the uniform profit-maximizing MSA-wide price will be....What this means is that a uniform price does not protect consumers in less competitive parts of the MSA from supracompetitive prices."[21] The question, then, is whether the MSA-wide prices charged by incumbent LECs are set significantly above their costs or above levels that would be yielded by effective competition. As discussed below, the incumbent

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[19] *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.").

[20] *See* Qwest Comments at 27-28 ("First, with occasional exceptions, the pricing options available to ILEC customers on all point-to-point routes throughout an individual MSA are essentially uniform....As a result, competitors (and customers) typically face the same price competition from the ILEC throughout any given MSA. In other words, when there is competition in one part of an MSA, customers across the MSA benefit from reduced pricing and better terms."); AT&T Reply Comments, WC Dkt. No. 05-25, at 32 (filed Feb. 24, 2010) ("*AT&T Reply Comments*") ("The effects of the pricing flexibility rules are further mitigated because the...pricing of special access services tends to be uniform throughout an MSA.").

[21] Declaration of Bridger M. Mitchell & John R. Woodbury, ¶¶ 44-46, attached to Reply Comments of Nextel, WC Dkt. No. 05-25 (filed July 29, 2005) ("*Mitchell-Woodbury Decl.*")

LECs' prices fail both of these standards, thereby showing that the presence of competition in a subpart of the MSA does not discipline incumbent LECs' MSA-wide prices.

Third, the incumbent LECs argue that limited competition is sufficient to prevent incumbent LECs from raising Phase II rates because of the substantial fixed costs that the incumbents would continue to incur when a customer is lost to a competitor.[22] But as Drs. Mitchell and Woodbury have explained, even if the incumbents are correct in asserting that high fixed costs might prevent them from further increasing prices in the future (because this would supposedly cause them to lose customers while continuing to incur high fixed costs), this does not mean that their *current* prices in Phase II areas are set above competitive levels.[23] In any event, there is reason to doubt the incumbents' theory. Because the incumbents' DS1 and DS3 output has been consistently increasing over the last almost 15 years, the incumbents have likely been able to spread their fixed costs over a greater number of circuits notwithstanding any (likely *de minimis*) losses to competitors.[24] Therefore, it appears that the incumbents LECs' costs per unit have been declining. The incumbents' own logic would yield the conclusion that their incentive to maintain reasonable prices has been *diminishing* as their special access output has been increasing.

[22] *See, e.g.*, Attach. A to Verizon Comments, Declaration of Michael D. Topper, ¶ 37 ("*Topper Decl.*") ("ILECs have large fixed network costs and relatively smaller marginal costs to serve additional users. This cost structure creates a strong incentive for an ILEC to retain a large volume of output over which to spread its fixed costs…"); AT&T Reply Comments at 35 ("In any event, given the structure of ILEC costs, and the risk of stranded investment, even a small number of competitors would have a powerful restraining effect on ILEC pricing because the loss of even a small number of customers would have a significant impact on ILEC profits."); Verizon Comments, Attachment C: Declaration of William E. Taylor, WC Dkt. No. 05-25, ¶ 75 (filed June 13, 2005).

[23] *See Mitchell-Woodbury Decl.* ¶ 82 (arguing that the ILECs' analyses "indicate only that a potential increase in price from the level of the current price could be defeated; it does not establish that in areas where a BOC has Phase II pricing flexibility, the current BOC special access price does not exceed the competitive price and that the BOC is not currently exercising market power. In particular, if the BOC has already set a profit-maximizing monopoly price for special access services in Phase II MSAs, then any increase in price will be unprofitable regardless of the size of the BOCs' margin.").

[24] *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."); Declaration of Alfred E. Kahn & William E. Taylor on Behalf of BellSouth, Qwest, SBC, and Verizon, RM-10593, at 12 (dated Nov. 27, 2002) ("*Kahn-Taylor Decl.*"), attached to Opposition of SBC, RM-10593 (filed Dec. 2, 2002) ("These data clearly show a rapid and accelerating growth of RBOC special access lines, averaging 30 percent per year over the 1996-2001 period.").

III. Incumbent LEC Special Access Prices Show That The Incumbents Possess and Exercise Market Power In Phase II MSAs

In addition to the incumbent LECs' extremely high and persisting market share, the available evidence shows that the incumbents have set their prices at unreasonably high levels in Phase II areas. This fact further supports the conclusion that the incumbent LECs possess market power. It also supports the conclusion that the current regulatory regime enables the incumbent LECs to exercise that market power to charge unreasonable rates in Phase II areas.

A. The Incumbents' Rates in Phase II Areas Are Almost Always Higher Than Their Rates In Areas Subject to Price Caps, Indicating The Exercise Of Market Power In Phase II Areas

Once incumbent LECs are granted Phase II pricing flexibility in a particular MSA, they almost always raise rates for both DS1 and DS3 channel terminations and transport service above rates charged in areas subject to price cap regulation.[25] The incumbents sustain that differential in nearly every instance for nearly every element and under nearly every pricing plan (i.e., month-to-month, term and discount plans).[26] Indeed, the GAO found that the rate differential persists even when taking individually negotiated contract tariffs into account. This is because such contracts, like the generally available volume/term discount plans, "provide overall discounts off of the list price, and...since price-flex list prices are higher on average than price-cap list prices, prices will remain higher in Phase II

[25] *See* National Regulatory Research Institute, *Competitive Issues in Special Access Markets*, at 24 (rev. ed. Feb. 2009) ("*NRRI Report*") (comparing pre-flexibility rates with ILEC prices charged in 2003, "Uri and Zimmerman found that in areas still under price caps, prices had declined. By contrast, many rates had risen in areas with pricing flexibility."); *GAO Report* at 13 ("Since Phase II pricing flexibility was first granted, list prices for dedicated access that apply under phase II, on average, having increased. Conversely, price-cap list prices available in Phase I and price-cap areas were pushed downward over the same period--largely by the CALLS Order. As a result, average list prices in areas with phase II flexibility are higher than average list prices in phase I and price cap areas.").

[26] *See e.g.*, Letter of Thomas Jones, Counsel, TWTC, to Marlene H. Dortch, Secretary, FCC, WC Dkt. No. 05-25, Attach. A: *Pricing Charts and Methodology for Pricing Charts* (filed July 9, 2009) ("*TWTC July 9, 2009 Letter*") (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); *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 ("[C]omparison 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.").

areas."[27] It is therefore not surprising that the GAO concluded that the *actual prices paid* in Phase II areas are higher than prices in Phase I areas.[28]

[confidential begin] [29] [30] **[confidential end]**

The GAO found only one possible exception to this persistent rate differential between price cap and Phase II rates. Average DS1 and DS3 prices in Phase II areas may be at or near the average DS1 and DS3 price cap prices charged in higher cost, rural areas that have not received any pricing flexibility (non-flex areas).[31] This outcome is the result of the unavailability of contract tariff discounts in non-flex areas.[32] Contract tariffs typically provide an "overlay" discount on top of

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[27] *GAO Report* at 13-14. *See also id.* at 27 ("[A]ccording to representatives of the incumbent firms, many of the largest customers in pricing flexibility markets are under price-flex contracts. Many of these contracts provide discounts off of the applicable price-cap or price-flex list price. Because of the differences in the underlying list prices, contract prices for dedicated access in phase II areas will still be higher than phase I areas."); *id.* at 39 ("In general, because many contracts provide for discounts off of the list price, effective prices for dedicated access under these contracts in phase II areas will generally be higher than in phase I areas because price flex-list prices are, on average, higher than price-cap list prices.").

[28] *See id.* at 14 ("Comparing average revenue across price-cap areas, phase I areas and Phase II areas as of 2005--the most recent period available--we found that average revenue in the 27 Phase II areas is higher, on average, than it is in the 29 phase I areas."); *id.* at 28 ("[A]verage revenue for channel terminations is higher, on average, in phase II areas than in phase I areas or price cap areas."); *id.* at 32 ("[T]he data show that average revenue in the phase II areas is about 4 percent higher for DS-1 channel terminations, and 24 percent higher for DS-3 channel terminations, compared with average revenue in the phase I areas.").

[29] **[confidential begin] [confidential end].**

[30] **[confidential begin] [confidential end].**

[31] While noting that its calculation for average revenue obtained by incumbents in non-flex areas was likely "biased upwards" because the non-flex price was taken from predominantly rural, higher priced zones, the GAO calculated that the non-flex average revenue was comparable to the average revenue per circuit in Phase II areas. *See GAO Report* at 58 ("The average [non-flex area] revenue is likely to be biased upward....Because areas still under price-cap regulation have not qualified for Phase I or phase II flexibility, these areas are likely to have lower business density. Therefore, a higher percentage of circuits are likely to be sold under zone 3 pricing, which is generally priced higher than circuits under zone 1 pricing....Because we do not have detailed data on the number of channel terminations sold under different zones in phase II areas, we were unable to correct for this bias.").

[32] There are relatively few non-flex areas. According to USTA, approximately two thirds of the MSAs nationwide have received at least Phase I pricing flexibility. *See* USTA Reply Comments, Attachment:

generally available volume/term discounts. While contract tariff discounts are not available in non-flex areas, volume/term discounts are available in all areas (i.e., non-flex, Phase I and Phase II areas).[33] When the contract tariff discount is applied to the higher Phase II tariff rates but not the non-flex rates, the rates in non-flex and Phase II areas converge.[34] Importantly, in order to obtain the prices similar to those available under price caps in high cost, high price zones (areas in which one would expect prices to be higher than in Phase II areas), competitors in Phase II areas are forced to sign up for contract tariff discounts which, as explained below, contain onerous terms and conditions. It follows that the convergence of certain non-flex and Phase II prices is not an indication that the prices offered in Phase II areas are reasonable.

It should be noted that many customers are either unwilling or unable to sign up for incumbent LEC contract tariffs. These customers, including XO, do not purchase a sufficient volume of special access circuits to motivate the incumbent LEC to enter into serious negotiations, and/or they are unwilling to agree to the unreasonable terms and conditions offered.[35]

High Capacity Service: Abundant, Affordable and Evolving, WC Dkt. No. 05-25, at iii (filed Feb. 24, 2010).

[33] *See GAO Report* at 4 ("Where neither trigger for competition is met, price-cap incumbents' prices remain subject to FCC's price cap and customers can only purchase dedicated access from the price-capped list prices (which can include volume and term discounts").

[34] *See id.* at 14 ("Comparing average revenue across price-cap areas, phase I areas, and phase II areas as of 2005—the most recent period available—we found that average revenue in the 27 phase II areas is higher, on average, than it is in the 29 phase I areas and not statistically different than average revenue in areas that are still under a price cap.").

[35] *See, e.g.,* Clancy Decl. ¶ 12 ("Covad often is unable to avail itself of the modest discounts offered on special access prices by ILECs….Covad is unable to agree to the terms and conditions of such discount plans. For example, discount plans that would require Covad to convert its base of UNEs to special access...would raise Covad's overall costs significantly. Percentage of 'spend' and growth requirements also are uneconomic and therefore are unacceptable to Covad."); Declaration of Mark Koppersmith of XO, ¶¶ 6-7 ("*Koppersmith Decl.*"), attached to *Covad et al. 2007 Comments* ("Verizon presented a proposal to XO that would require XO to convert all of its UNE-based services one year prior to the date the FCC is expected to rule on its pending petitions for forbearance on section 251 unbundling obligations. XO rejected this…proposal….AT&T developed revenue commitments that would require XO to convert all UNEs to special access in order to get circuit portability. Another proposal by AT&T…required XO to have specific UNE to- special access ratios….AT&T's proposal would require all additional [growth] to be purchased as special access rather than UNEs….XO rejected these unreasonable and anticompetitive proposals."); *Koppersmith Decl.* ¶ 8 ("Another tactic employed by certain incumbent LECs is to make a discount offer conditioned on a requirement that XO abstain from participation in certain FCC proceeding(s) in which the incumbent LEC has a position it is certain XO opposes. XO rejected this unreasonable anti-competitive proposal.").

The incumbents do not dispute these facts. Instead, they argue, without basis, that price cap rates are set below competitive levels and below the incumbent LECs' costs and that Phase II rates are set equal to the "true" competitive level.[36] They argue that the FCC anticipated in the *Pricing Flexibility Order* that price cap rates were below incumbents' costs , and that Phase II prices would rise as a result.[37] In making this argument, the incumbents overstate the FCC's prediction. The FCC observed that Phase II rates might increase for "*some* customers" and that "*some* access rate increases may be warranted, because our rules may have required incumbent LECs to price access services below cost in *certain* areas."[38] By contrast, nearly universal rate increases following the grant of Phase II pricing flexibility along with higher average prices in Phase II areas is *prima facie* evidence of the exercise of market power in Phase II areas.

More fundamentally, the incumbents have not provided evidence that price cap regulation resulted in a single below cost price for a DS1 or DS3 service now offered in a Phase II area. This is a telling omission. If the incumbents truly believed that their prices were set below their costs or the "competitive level" even in some 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

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[36] *See* Declaration of Timothy J. Tardiff & Dennis L. Weisman ¶¶ 29 ("*Tardiff-Weisman Reply Decl.*"), attached as Exh. 1 to Reply Comments of Qwest, WC Dkt. No. 05-25 (filed Feb. 24, 2010) ("Qwest Reply Comments"). ("[T]he initial price cap index, in combination with annual updates from the application of X factors, may well have resulted in rates below a proper measure of forward-looking costs at the onset of pricing flexibility, given factors such as the erosion in scale economies and the increased risk posed by ever-increasing competition for special access and other services. If so, we would not necessarily expect special access prices to be trending downward, as regulated rates were already below market rates; we might well expect them to trend up, even in highly competitive markets."); Qwest Reply Comments at n.7 ("If rates in non-Phase II areas are higher than their counterparts in Phase II areas that the Commission has found competitive, it would not necessarily follow that those rates are supracompetitive, and further inquiry would be needed to determine whether the discrepancy is due to factors such as the higher per-unit costs in non-Phase II areas."); *Topper Reply Decl.* ¶ 20 ("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.").

[37] Verizon Reply Comments at 6 ("[T]he Commission acknowledged that, once pricing flexibility was implemented, special access prices would not necessarily decline in all cases, but would instead move both up and down, pushing toward some equilibrium price, consistent with what occurs in a competitive market. The Commission noted, for example, that, in some cases, special access prices might rise because our rules may have required incumbent LECs to price access services below cost.") (internal citations omitted).

[38] *Pricing Flexibility Order* ¶ 155 (emphasis added).

would have been able to present a case to the FCC for under-earning.[39] Indeed, given the large amounts of money at stake, the incumbents should have logically made it their highest priority to marshal and file the best available evidence demonstrating the scope of their under-earning. But they have not done so. Moreover, they have repeatedly argued that their special access costs are unknowable.[40] Therefore, their assertion that price cap rates are below their costs and that Phase II rates are set at competitive levels should be rejected.

B. Incumbent LEC Special Access Rates Exceed Their Forward Looking Costs And Competitive Levels

As Drs. Besen and Farrell have explained, the clearest way to measure the incumbent LECs' exercise of market power is the extent to which their prices exceed their costs. The overwhelming evidence in the record shows that incumbent LEC Phase II prices are set well above their costs. Two available measures of incumbent LEC forward-looking costs prove this point.

First, incumbents' Phase II prices are set well above UNE rates (*which exceed forward-looking costs*)[41] in nearly every instance, and in many cases more than twice as high, demonstrating that the incumbents are earning returns well above their costs.[42] The substantial difference between UNE rates

[39] *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 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)).

[40] *See, e.g.,* Verizon Comments at 43 ("Even if the costs or profits of special access services were relevant to assessing competition for high capacity services, it would not be practical or feasible for the Commission to measure or calculate them.").

[41] *See Implementation of the Local Competition Provisions in the Telecommunications Act of 1996; Interconnection Between Local Exchange Carriers and CMRS Providers*, First Report and Order, 11 FCC Rcd. 15499, ¶ 245 (1996) ("*Local Competition Order*") ("In addition, the pricing standard we implement pursuant to section 252(d)(1)(B), which allows incumbent LECs to receive not only their costs but also a reasonable profit on the provision of unbundled elements, should further alleviate concerns regarding sham requests.").

[42] *See supra* note 26; Letter of Brett Heather Freedson, Counsel, Covad *et al.*, to Marlene H. Dortch, Secretary, FCC, WC Dkt. No. 05-25 *et al.*, (filed Aug. 10, 2007) (attaching charts comparing UNE rates with, AT&T, Verizon and Qwest, price cap and Phase II rates on month-to-month, one year and three year term plans); ATX *et al. Aug. 8, 2007 Comments* at 37 and Attach. 4: *Comparison of Qwest Pricing Flexibility. Price Cap and UNE Rates* ("[B]ased on a sample of Qwest states, for a one-year term Zone 1 DS1 circuit with two channel terminations and 10 miles of channel mileage, Qwest's

and Phase II prices persists even when comparing UNE rates, which are available on a month-to-month basis, with special access rates subject to substantial volume/term discounts.[43] The most appropriate "apples-to-apples" comparison is UNE rates versus month-to-month rates for special access. That comparison shows special access prices wildly in excess of UNE prices.[44]

The incumbent LECs argue that UNE rates based on forward-looking costs are not the appropriate measure of whether special access rates are just and reasonable.[45] But it has been the FCC's longstanding goal to drive incumbent LEC access rates toward forward looking costs through either competition or regulation.[46] Indeed, in the *CALLS Order*, the FCC invited the incumbents to

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pricing flexibility and price cap rates are 87% and 169% and 87% greater…than the average of UNE rates offered in Arizona, Minnesota, Colorado, Washington, and Iowa."); *Covad et al. 2007 Comments* at 17 and Attach. 1 ("In all the states analyzed, 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 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."); *id.* at 19, & Attachment 2 ("The fixed month-to-month recurring Phase II rates for most of the areas analyzed are over 100% higher than for the comparable UNE services, with both price cap rates and Phase II rates over 400% higher than the UNE rates in Illinois. The greatest disparity is in mileage rates, where special access rates in some instances are over 10,000% higher than the comparable UNE rate in the state. For example, in Texas the UNE fixed monthly and mileage rates are $33.767 and $0.1005 respectively; the price cap fixed monthly and mileage rates are $62.00 and $15.50; and the Phase II fixed monthly and mileage rates are $85.00 and $18.00.").

[43] *See, e.g., supra* note 42.

[44] *See supra* note 42.

[45] *See, e.g.,* Verizon Reply Comments at 34-39; AT&T Reply Comments at 52; *Tardiff-Weisman Reply Decl.* ¶¶ 22-24.

[46] *See Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers et al.*, Sixth Report & Order in CC Docket Nos. 96-262 and 94-1 *et al.*, 15 FCC Rcd 12962, ¶ 20 (2000) ("*CALLS Order*") ("In the *Access Charge Reform Order*, the Commission also stated that its primary method for bringing about cost-based access charges was by letting competition establish efficient rates….To the extent that competition did not fully achieve the goal of moving access rates toward costs, the Commission reserved the right to adjust rates in the future to bring them into line with forward-looking costs. To assist in that effort, the Commission said it would require price cap LECs to start forward-looking cost studies by no later than February 8, 2001 for all services then remaining under price caps.").

submit forward looking cost studies instead of submitting to X-factor driven rate reductions.[47] The FCC anticipated that if, by the end of the five-year period covered by the *CALLS Order*, incumbent LEC prices were not set at forward looking costs, it would consider additional action.[48] Now, five years after the expiration of that five-year period, the persistent differential between Phase II and UNE rates argues that such additional action is necessary.[49]

Second, it is also significant that the incumbent LECs' Phase II rates substantially exceed prices charged by competitors for DS1 and DS3 services in nearly every case.[50] For example, not only are competitors' channel termination rates lower than incumbents' rates for the same services, but competitors generally charge *nothing* for loop mileage while incumbent LEC interoffice mileage rates are set at extremely high levels.[51]

The incumbents argue that competitor rates are not a valid proxy for incumbent LECs' rates because the incumbents' incremental costs of providing DS1 and DS3 service are higher than competitors' costs.[52] But there is no basis for this assertion with regard to DS1 and DS3 services

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[47] *See CALLS Order* ¶ 29 ("Price cap LECs will be able to choose between having these interim rate-level components apply for the full five years or having their rates reinitialized based on forward-looking economic cost.").

[48] *See id.* ¶ 60 ("For those carriers that accept the CALLS Proposal, we are extending for five years the period during which we will allow the market-based approach to bring interstate access prices toward forward-looking economic cost.").

[49] Indeed, Qwest argued that the purpose of price cap regulation is "to provide the regulated firm with the incentives to discover" what its forward looking costs are. *See Tardiff-Weisman Reply Decl.* ¶ 23.

[50] *See supra* note 26; Comments of Global Crossing, WC Dkt. No. 05-25, Declaration of Janet Fischer, ¶ 6, Tables 5 & 6 (Aug. 8, 2007) (showing that when comparing special access prices under both price caps and price flex with prices offered to Global Crossing by 4 four alternative providers, price cap and price flex rates were "typically two to three times higher than competitive carriers, and the pricing flexibility price is higher than the price cap price for the same facility.").

[51] *See TWTC July 9, 2009 Letter,* Attachment A at 1 ("To the extent that competitors assess a separate charge for mileage, those charges are incorporated into the amounts set forth in the charts. **[confidential begin] [confidential end]**."); Reply Comments of WilTel, WC Dkt. No. 05-25, at Ex 1 (filed July 29, 2005) (pricing charts showing that only incumbents, not competitors, charge for mileage).

[52] *See* AT&T Reply Comments, Appendix A at 9 ("Not surprisingly, many CLECs enter a market by first providing service in the highest-density, highest-demand, highest-bandwidth, and cheapest-to-serve segments of the market, which yields per-line costs (and prices) below that of the ILEC, which is required to serve *all* customers at *all* bandwidths *throughout* MSAs.") (emphasis in original); Qwest Comments at 24 ("CLECs enjoy scale economies in their provision of [DSn] services, and their pricing reflects that fact.").

provided by incumbents in areas served by competitors. Incumbents' incremental costs to provide DS1s and DS3s are almost certainly lower than competitors' costs because of the incumbents' greater economies of scale and scope and the ubiquity of their largely depreciated networks.[53] As the FCC and NRRI have found, DS-1 and DS-3 services, when provided by the incumbent, are generally provided via copper or already existing facilities.[54] As the incumbents themselves acknowledge, their additional costs to "turn up" the circuit are minimal.[55]

In addition, as the incumbent LECs acknowledge, they often provide DS-1 special access service using HDSL technology.[56] In its recently-released Broadband Cost Report, the FCC concluded that the incumbents' incremental costs of providing DSL service are very low.[57] By contrast, the FCC

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[53] *See Mitchell-Woodbury Decl.* ¶ 53; *Tardiff-Weisman Reply Decl.* ¶ 13 (noting that Qwest's "investments have been substantially depreciated - a condition that describes Qwest and the other incumbents."); Qwest Comments at 47 ("TDM-based DSn-level circuits...ILECs typically provide over legacy copper facilities...ILECs therefore no longer concentrate their investment in DSn-level facilities, many of which are substantially depreciated.").

[54] Indeed, TWTC and PAETEC are rarely charged "special construction" fees when ordering DS1 and DS3 facilities from the incumbents, indicating that the necessary facilities are almost always already in place. *See also Comment Sought on Impact of Middle and Second Mile Access on Broadband Availability and Deployment*, NBP Public Notice #11, 24 FCC Rcd. 12470, at 3 (2009) ("For instance, will DS1 and DS3 connectivity over copper wire networks for the middle mile be sufficient for a community's broadband needs over the next 5-10 years?"); *Comments Invited on Application of Qwest Corporation to Discontinue Domestic Telecommunications Services*, Public Notice, 2005 FCC LEXIS 2595, at *1-2 (2005) ("Qwest indicates that DS1 radio interface and DS3 radio interface is a point-to-point private line service designed to be carried from the customer's premises to the Qwest serving wire center over a microwave link. Qwest states that the product is intended to provide a DS1 or DS3 service to customer locations that are too remote to be connected by a traditional copper loop."); *NRRI Report* at 44 ("While market concentration data cannot establish market power in the general case, it has unusual value in special access markets....ILECs have distribution facilities at or near almost every customer location.").

[55] *See Topper Declaration* ¶ 37 ("ILECs have large fixed network costs and relatively smaller marginal costs to serve additional users.").

[56] *See* Century Link, Wholesale - Local Services, *at* http://www.centurylink.com/business/Wholesale/InterconnectionServices/QuickLinks/glossary.jsp (last visited May 24, 2010) ("HDSL Electronics - High bit-rate digital subscriber line. A technology used to provide services of up to 1.536 Mbps of synchronous capacity over a four-wire loop of two copper pairs. HDSL is a common means by which ILECs provision DS1 services and unbundled network elements.").

recognized that "[a] new entrant would not have the same starting point"[58] and that its costs would be much higher than the incumbent's.

The incumbent LECs also argue that their DS1 and DS3 costs are higher than competitors' costs because incumbents are required to serve all areas, including higher cost rural areas that competitors generally choose not to serve.[59] But incumbent LECs can disaggregate special access prices by up to seven zones per study area.[60] Therefore, the incumbent LECs' relatively higher cost of providing service in outlying areas should not affect the rates that they charge in urban cores and office parks where they face competition. Indeed, the FCC designed its special access pricing zone system to ensure that incumbents' obligation to serve higher cost areas would not affect their rates in lower cost areas.[61]

C. Any Decline In The Incumbent LECs' Average Price Over Time Is Not Relevant To Whether They Are Exercising Their Market Power

The incumbents make much of the fact that their average price per DS1 and DS3 has declined over time.[62] But this assertion, even if true, is irrelevant to whether the incumbent LECs are exercising

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[57] The FCC concluded that copper-based 12,000 ft. DSL "has the best economics while still meeting the National Broadband Availability target because it requires the least amount of network/replacement building." *Broadband Cost Report* at 59. Adding additional DSL customers to an already DSL-enabled central office often only involves supplying additional DSL ports/line cards at the central office, labor costs to configure the circuit, customer electronics, and, if necessary, additional incremental transport capacity. *See id.* at 88-89.

[58] *Id.* at 54.

[59] AT&T Reply Comments at 62 ("Second, Dr. Mitchell's argument assumes that the ILECs' alleged larger scale necessarily translates into lower costs. In fact, the ILECs' larger scale is attributable in part to their carrier of last resort and other service obligations that require ILECs' to serve very high cost customers.").

[60] *Pricing Flexibility Order* ¶ 62 ("[We] permit price cap incumbent LECs to define zone pricing plans in any manner they wish, so long as each zone, except the highest-cost zone, accounts for at least 15 percent of the incumbent LEC's trunking basket revenues in the study area....[T]he limit we adopt permits a maximum of seven zones, which we believe should provide the ability to adjust to any likely variation in cost conditions").

[61] *Id.* ¶¶ 61, 64 ("As the Commission observed in the *Access Reform NPRM*, averaging across large geographic areas distorts the operation of markets in high-cost areas because it requires incumbent LECs to offer services in those areas at prices substantially lower than their costs of providing those services....[C]hanges in incumbent LEC pricing zones resulting from this Order are likely to *increase* the degree to which trunking service prices reflect cost and thus would decrease the likelihood of cross-subsidization.") (emphasis in original).

[62] *See, e.g.*, AT&T Comments at 25; Verizon Comments at 6-8.

market power in Phase II areas. As Dr. Stanley Besen and Dr. Joseph Farrell have explained, a decline in a firm's prices, by itself, says nothing about whether that firm's price is set at supracompetitive levels.[63] Rather, incumbents' profit margins are the best measure of the extent to which incumbents have market power.[64] The monopoly price can rise or fall for many reasons. For example, as Drs. Besen and Farrell have explained, a monopolist's price reduction would be consistent with declining marginal cost as output increases.[65] AT&T no doubt understands that the direction of prices has no bearing on market power because legacy SBC argued (in response to legacy AT&T's petition for a special access rulemaking and allegations of rising special access rates) that special access price *increases* were not evidence of the exercise of market power.[66] Qwest makes a similar argument in its most recent reply comments.[67]

IV. Volume/Term and Contract Tariffs Constitute The Exercise Of Market Power By Incumbent LEC

As many commenters have explained, incumbent LECs charge prices for month-to-month special access services that far exceed cost-based month-to-month UNE prices. The incumbents argue that it is not appropriate for the Commission to focus on month-to-month special access prices because

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[63] *See TWTC July 9, 2009 Letter*, Attach B: Declaration of Stanley M. Besen ¶¶ 3-4 ("*Besen Decl.*"); Reply Declaration of Joseph Farrell on Behalf of CompTel, ¶¶ 41- 44 ("*Farrell Decl.*"), attached to Reply Comments of CompTel *et al.*, WC Dkt. No. 05-25 (filed July 29, 2005).

[64] *See Besen Decl.* ¶ 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); *Farrell Decl.* ¶ 42 ("While there are pitfalls in using price-cost data to make inferences about the state of competition, it is clear that in any such endeavor it logically is the *relative levels* of price and cost, not the *rate of change* of price, that matter.") (emphasis in original); *see id.* ¶ 43 (noting that, in his academic papers, ILEC Declarant William Taylor "observed that the presence of high operating margins supports the conclusion that regulated competition has not produced substantial consumer benefits. Dr. Taylor also recognizes that lower prices and increased demand can sometimes be mistakenly ascribed to competition.").

[65] *See Besen Decl.* 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."); *Farrell Decl.* ¶ 41 ("Even a monopoly will reduce price if marginal costs fall or if demand becomes more elastic. In addition a firm with decreasing, but still very substantial, market power will reduce prices for that reason.").

[66] *See Kahn-Taylor Decl.* ¶ 14 ("[A]n increase in prices, revenue and demand volumes is not necessarily evidence that a large firm possesses market power.").

[67] *See Tardiff-Weisman Reply Decl.* ¶ 34 ("[E]ven if special access prices had not trended downward over time, this would not be dispositive of market power[.]").

most special access customers pay "discounted" special access prices under volume/term commitment plans.[68] Even on its own terms this assertion fails because, as also explained, the incumbent LECs' "discounted" prices far exceed UNE prices and competitors' prices. But the Commission must recognize that special access volume/term plan and contract tariffs *are themselves an exercise of incumbent LEC market power*.[69] The result of that conduct is essentially to impose costs on special access purchasers and bestow benefits on incumbent LECs that are not reflected in the prices paid.[70]

As many commenters have explained, incumbent LECs' discount plans contain numerous unreasonable terms and conditions including onerous minimum annual revenue commitments ("MARC") or circuit commitments which "ratchet up" if the MARC or circuit commitment is exceeded (thereby locking-in excess demand), limitations on UNE purchases and even unwritten agreements to forgo regulatory advocacy.[71] The incumbent LECs' pricing strategy is consistent with

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[68] *See* AT&T Comments at 13.

[69] As the FCC has repeatedly found, incumbents can exercise their market power through the imposition of unreasonable and discriminatory price and non-price terms. *See, e.g., Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements et al.*, Report and Order and Memorandum Opinion and Order, 22 FCC Rcd. 16440, ¶ 70 (2007) ("AT&T's, Qwest's, and Verizon's exclusionary market power [over local exchange services] raises the possibility that they could leverage market power in the telephone exchange service or exchange access markets to impede competition in the in-region, interstate, long distance services market, through discrimination against competitors, improper cost shifting, or price squeezes. *See, e.g., LEC Classification Order,* 12 FCC Rcd at 15815-19, paras. 103-08, 15821-26, paras. 111-19, 15829-33, paras. 125-30, & 15847-15857, paras. 158-75 (describing the incentives, ability, and means for an incumbent LEC to improperly allocate costs, engage in price and non-price discrimination, and engage in a price squeeze).").

[70] For example, assume that an incumbent LEC with market power believes that its profit maximizing price on a month-to-month DS1 is $160. The incumbent LEC may be willing to lower that price to $100 if the competitor is willing to (1) sign up for a five year commitment; (2) lock in 90 percent of its current demand with the incumbent LEC; and (3) substantially limit its UNE purchases. The revenue that the incumbent LEC loses per DS1 may be equal to the value the incumbent LEC gains through the imposition of the contract conditions. Indeed, that is likely the case or the incumbent would not have offered the contract terms in the first place. In this way, the incumbent LEC exercises its market power through unreasonable terms and conditions, instead of entirely through supracompetitive month-to-month prices.

[71] *See, e.g., supra* note 35; *see also* Sprint Nextel Comments, Attach. A: Declaration of Bridger M. Mitchell ¶ 125 ("Sprint has filed evidence of five categories of terms and conditions contained in BOC contracts that have the effect of locking in customers and forestalling competitive entry : Revenue commitment levels set at up to 100 percent of current demand levels; Shortfall penalties if actual demand falls below specified levels; Overage penalties if actual demand exceeds specified levels; Termination liabilities for exiting the plan prior to the scheduled expiration date; and Onerous circuit migration charges and restrictions."); PAETEC *et al.* Comments at 82 ("As the chart (a copy of which has been attached here as Exhibit 2) shows, AT&T imposes a requirements in its contract tariffs

economic theory that monopolists will set the non-discounted price at supracompetitve levels in order to extract monopoly rents through unreasonable terms and conditions.[72] Incumbent LECs may exercise their market power by forgoing per-unit special access profits (through "discounted" prices) in return for non-price conditions that provide a greater benefit to the incumbent. For example, an incumbent LEC can ensure that a "discount" plan yields an increase in its profit margins if it can extract a CLEC's agreement to limit UNE purchases in exchange for special access discounts.

Such discount plans also harm competition because they tie the demand of the customer at locations where there is no competition to demand at the limited number of locations where there is competition. As a result, even though non-incumbent LEC wholesalers offer on-net service in certain locations at prices below those charged by the incumbent, the buyer would be worse off choosing the competitive wholesaler in many instances. This is because the penalties that the purchaser would need to pay or the discounts that the purchaser would lose due to missed volume commitments made to the

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ranging from required conversions of UNEs to demands that a certain number or percentage of circuits be migrated from another carrier to AT&T. Verizon's contract tariffs contain similar provisions, mandating the conversion of UNEs in certain cases and also linking in at least a few contracts the purchases of more competitive transport facilities to lower rates for bottleneck channel terminations."); *GAO Report* at 30 ("Customers who sign contracts may need to meet various conditions, which competitors argue limits customers' ability to choose another provider. These conditions include such things as revenue guarantees, requirements for shifting business away from competitors, and severe termination penalties.....[Contracts with revenue guarantees] may inhibit choosing competitive alternatives because the customer does not receive the applicable discount, credit, or incentive if the revenue targets are not met and additional penalties may also apply. Unless a competitor can meet the customer's entire demand, the customer has an incentive to stay with the incumbent and to purchase additional circuits from the incumbent, rather than switch to a competitor or purchase a portion of their demand from a competitor—*even if the competitor is less expensive*.") (emphasis added).

[72] *See Farrell Decl.* ¶ 4 ("[W]hen a monopoly offers proportional or relative discounts off its undiscounted prices in order to induce customers to agree to exclusionary provisions, it has an incentive to set the undiscounted price above even the monopoly level (because, rather than simply deterring demand, an increase above the monopoly level steers customers into the discount plans and also brings the discount prices closer to the monopoly level); *id.* at n.2 ("The economics of price-setting once a subset of customers become entitled to a percentage discount off a list price are analyzed by Borenstein, Severin, 1996. 'Settling for Coupons: Discount Contracts as Compensation and Punishment in Antitrust Lawsuits,' *Journal of Law & Economics*, University of Chicago Press, vol. 39(2), pages 379-404. Professor Borenstein shows that such discounts do not lower prices overall but rather implement a transfer from non-discount customers to discount customers, with almost no effect on average price or on the seller's profit. Moreover, if entitlement to the discount is based on agreeing to exclusionary terms, such arrangements further harm consumers in the long run. In price flex areas, even basic tariffs are unregulated, and the rates in these tariffs can be, and have been, increased by the ILEC.").

incumbent might well exceed the cost savings associated with purchasing a small number of circuits from a non-incumbent LEC wholesaler.[73]

In their recently-filed comments, the incumbent LECs try to defend the structure and terms of their discount plans, but there is no basis for their arguments. *First*, AT&T argues that "the discount plans at issue are the same mechanisms used in other highly competitive marketplaces"[74] and competitive wholesalers also offer discounts if customers purchase larger volumes of circuits. But as PAETEC and others have shown, the harms to competition that result from these discount plans arise from the fact that a substantial portion of the special access market is *not competitive.*[75]

AT&T states that "a large percentage of Time Warner Telecom's customers also have contracts to which they commit a percentage of their purchases with Time Warner Telecom." This is no doubt true, but the percentage of a wholesale purchaser's total circuits that are "locked-in" with TWTC or, indeed, any other non-incumbent LEC competitor, is miniscule. The wholesale purchaser is therefore free to fulfill the majority of its demand from other providers without any risk of breaching its commitment with TWTC.

Second, AT&T also argues that discount plans are only harmful if the discounter succeeds in a predatory strategy by pricing elements below cost and driving competitors out of the market.[76] But as explained above, the public interest harms caused by the discount plans do not arise from incumbents pricing services below cost, but rather from tying access to services at locations where there is no competition to services at locations where competition does exist. Therefore, the incumbents' discount plans should properly be analyzed as illegal tying arrangements through the use of bundled discounts, where the bundle is defined as locations with competition and locations without competition. As

[73] As economist Michael Pelcovits has explained, "[t]he key to successful exclusionary pricing is to condition the pricing of the monopoly portion of the customer's demand on the choices the customer makes for the competitively sensitive portion of demand. The customer then pays a higher price on the monopoly demand if he deals with a competitor on the competitively sensitive demand." Reply Comments of WorldCom, Attachment A: Declaration of Michael D. Pelcovits, RM- 10593, at 7 (filed Jan. 23, 2003).

[74] AT&T Comments at 77.

[75] *See* TWTC Comments at 22; PAETEC Comments at 80-81; *see also Lepage's, Inc., v. 3M*, 324 F.3d 141, 155 (3rd Cir. 2003) ("The principal anticompetitive effect of bundled rebates as offered by 3M is that *when offered by a monopolist* they may foreclose portions of the market to a potential competitor who does not manufacture an equally diverse group of products and who therefore cannot make a comparable offer.") (emphasis added).

[76] *See* AT&T Comments at 76.

TWTC has explained, courts have found that *above cost* bundled discounts offered by firms possessing a monopoly over a portion of the bundle constitutes a violation of the antitrust laws.[77]

In sum, it is clear that the provisions and structure of the incumbent LECs discount plans coupled with high Phase II rates prove that the incumbent LECs are exercising their market power in Phase II areas.

V. Cable Companies' HFC-Based Services and Wireless Service Are Not Viable Substitutes for Wireline Special Access Services In The Vast Majority of Cases

While any analysis of the special access market must take into account intermodal competition to the extent that it exists, the available evidence indicates that cable companies' HFC-based services and wireless services are not viable substitutes for incumbent LEC DS1 or DS3 special access services in the vast majority of cases. This is not to say that *no* business customers view HFC-based and wireless services as substitutes for special access service. Indeed, some do. But the relevant inquiry is whether a *sufficient number* of customers would shift to HFC-based or wireless services to prevent incumbents from maintaining supracompetitive special access prices. As explained in detail below, the evidence already on the record demonstrates unequivocally that this is not the case.

As many commenters have argued, the FCC should follow the methodology set forth in the FTC-DOJ Horizontal Merger Guidelines[78] for determining whether intermodal competitors' services should be considered part of the special access product market.[79] Under that methodology, product markets are defined based on customer demand.[80] Specifically, a product market is a product or group

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[77] *See TWTC July 9, 2009 Letter* at 22 ("The courts have held that such contracts are best analyzed as illegal tying arrangements in which the monopolist ties the portion of the demand that only it can fulfill to the portion of the demand that is subject to competitive supply"). *id.* at n.63 ("*See Lepage's, Inc., v. 3M*, 324 F.3d 141, 155 (3rd Cir. 2003) ('[Bundled discount offers] are best compared with tying, whose foreclosure effects are similar') (citing Phillip Areeda & Herbert Hovenkamp, Antitrust Law P 794, at 83 (Supp. 2002))").

[78] *See* U.S. Department of Justice and Federal Trade Commission, Horizontal Merger Guidelines (Apr. 2, 1992, rev. Apr. 8, 1997) ("*FTC-DOJ Horizontal Merger Guidelines*" or "*Guidelines*").

[79] *See* New Jersey Rate Counsel Reply Comments, WC Dkt. No. 05-25, at 15 (filed Feb. 24, 2010); NoChokePoints Reply Comments, WC Dkt. No. 05-25, at 17 (filed Feb. 24, 2010); TWTC Reply Comments, WC Dkt. No. 05-25, at 2 (filed Feb. 24, 2010); XO Reply Comments, WC Dkt. No. 05-25, at 1-2 (filed Feb. 24, 2010); NoChokePoints Comments at 9; PAETEC *et al.* Comments at 28-29, TWTC Comments at 6-7; XO Comments at 2-3.

[80] *Guidelines.* § 1.0 ("Market definition focuses solely on demand substitution factors -- i.e., possible consumer responses."). In particular, the inquiry concerns the extent to which customer demand is elastic or inelastic. If buyers are more likely to switch products or eliminate purchases all together in response to a price increase, they are considered to have "elastic" demand; if they are less likely to switch or eliminate purchases all together in response to a price increase, they have "inelastic