Atlantic and NYNEX territories.[37]

The Joint Commenters provide voice and data services to customers in the retail business services market. Some of these business customers' locations offer sufficient revenue opportunities to enable competitors to recover the costs of deploying their own last-mile facilities to such locations. However, because many of these customers' locations do not provide this level of revenue opportunities, competitors like the Joint Commenters must often lease access to such facilities from other carriers.[38] Unfortunately, as described in Section II.A *supra*, incumbent LECs own the only last-mile facilities to the vast majority of commercial buildings in their service areas. Thus, at many locations, the Joint Commenters have no choice but to purchase these last-mile facilities as special access services from incumbent LECs.

When a competitor purchases a DS1 or DS3 special access service from an incumbent LEC, the incumbent LEC generally charges: (1) an initial nonrecurring charge ("NRC") when the circuit is installed; and (2) a monthly recurring charge ("MRC") for each month that the

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[37] *See* Verizon Telephone Companies Tariff F.C.C. No. 1 § 25.1; Verizon Telephone Companies F.C.C. Tariff No. 11 § 25.1. tw telecom, Level 3, and others have previously submitted detailed descriptions of other incumbent LEC exclusionary purchase arrangements and their impacts on the market for special access services in the record of this proceeding. *See, e.g.*, Letter from Thomas Jones & Matthew Jones, Counsel for tw telecom, to Marlene H. Dortch, Secretary, FCC, WC Docket No. 05-25 *et al.*, Highly Confidential Attachment (filed Apr. 11, 2012) ("*tw telecom April 11, 2012 Letter*") (describing the direct impact on tw telecom of the incumbent LEC purchase arrangements under which tw telecom purchases services); Letter from Michael J. Mooney, General Counsel, Regulatory Policy, Level 3, to Marlene H. Dortch, Secretary, FCC, WC Docket No. 05-25 *et al.*, at 8-16 (filed Feb. 22, 2012) ("*Level 3 February 22, 2012 Letter*") (describing the wide-ranging impacts of various incumbent LEC exclusionary purchase arrangements); **[BEGIN HIGHLY CONFIDENTIAL]** [redacted] **[END HIGHLY CONFIDENTIAL]**

[38] *See generally* tw telecom Build/Buy Analysis (attached hereto as "Appendix C") ("*tw telecom Build/Buy Analysis*").

circuit remains in service. The incumbent LECs' undiscounted rates for special access services are extremely high. For example, for a DS1 channel termination in legacy Southwestern Bell territory, AT&T charges an installation NRC of $900.00 and MRCs that range from $195.00 to $205.00.[39] Similarly, for a DS1 channel termination in legacy Bell Atlantic territory, Verizon charges an undiscounted installation NRC of $355.00 and MRCs that range from $197.00 to $310.64.[40] These rates are so high as to be cost prohibitive for competitors seeking to provide services to retail business customers. Incumbent LECs have an incentive to keep these undiscounted rates very high in order to induce competitors to agree to exclusionary purchase arrangements that further cement the incumbents' market power.[41]

Incumbent LECs offer discounts off of these rates to buyers that commit to purchasing a circuit for a fixed period of time. For example, in legacy Southwestern Bell territory, if a customer commits to purchasing a DS1 channel termination from AT&T for a term of seven years, AT&T will waive its $900.00 NRC altogether, and will charge the customer MRCs that range from $90.00 to $105.00 per channel termination, a discount of up to 53.85 percent off of its undiscounted MRCs.[42] Similarly, in legacy Bell Atlantic territory, if a customer commits to purchasing a DS1 channel termination from Verizon for a term of seven years, Verizon will

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[39] *See* Southwestern Bell Tariff F.C.C. No. 73 § 7.3.10(F)(1). These rates do not include the cost of interoffice transport. *See id.* § 7.3.10(F)(2).

[40] *See* Verizon Telephone Companies Tariff F.C.C. No. 1 § 7.5.9(A)(1). These rates also do not include the cost of interoffice transport. *See id.* § 7.5.9(B)(1)(b).

[41] *See* Reply Declaration of Joseph Farrell on Behalf of CompTel, ¶ 21 (dated July 29, 2005) (attached to Reply Comments of CompTel *et al.*, WC Docket No. 05-25 *et al.* (filed July 29, 2005)) ("[O]nce an ILEC has contracted with some of its customers for a percentage discount off the month-to-month tariff, it has an incentive to raise the latter above the level that it would have chosen otherwise.").

[42] *See* Southwestern Bell Tariff F.C.C. No. 73 § 7.3.10(F)(10.4)(1).

charge the customer a $1.00 NRC rather than its undiscounted $355.00 NRC, and will charge the customer MRCs that range from $118.20 to $186.39 per channel termination, a discount of approximately 40 percent off of its undiscounted MRCs.[43] Clearly, these discounts are substantial. However, they come with a heavy burden. If a competitor ceases purchasing a special access service prior to the expiration of its commitment term, the incumbent LECs impose an early termination penalty, which is often very large.[44]

These early termination penalties disproportionately harm competitors that use leased incumbent LEC special access as an input to services offered to retail customers. This is because the length of time for which a competitor needs a special access circuit at a particular location depends on the length of time that a retail customer continues to purchase service from the competitor at that location. If the competitor's retail customer purchases services at a location for a time period that is shorter than the per-circuit term commitment that the competitor has been effectively forced to make to the incumbent LEC, then the competitor becomes subject to an early termination penalty due to circumstances beyond the competitor's control. For example, assume that a competitor purchases a channel termination from AT&T pursuant to a seven-year commitment term, and the competitor uses that channel termination to serve a retail customer

[43] *See* Verizon Telephone Companies Tariff F.C.C. No. 1 § 7.5.16(D).

[44] As Drs. Besen and Mitchell explain, early termination penalties can be justified as a means of recovering customer-specific, sunk costs associated with providing a circuit. *See Besen and Mitchell Paper* ¶¶ 56-57. However, incumbent LECs often exploit this mechanism by imposing early termination penalties that are far greater than any unrecovered customer-specific, sunk costs in order to prevent competitors from purchasing services from an alternative wholesale provider. For example, in legacy Southwestern Bell territory, AT&T applies a penalty equal to 40 percent of the MRC for the service, multiplied by the number of months remaining in the commitment term. *See* Southwestern Bell Tariff F.C.C. No. 73 § 7.2.22(G). Verizon applies a more complicated formula, but this formula yields early termination penalties that are often very large as well. *See* Verizon Telephone Companies Tariff F.C.C. No. 1 § 7.4.17(D).

that signs a service contract that is two years in duration. Note that the competitor commits to a seven-year term in order to obtain a low enough price to compete in the downstream retail market. If the retail customer does not renew its contract with the competitor at the end of the initial two-year term, the competitor would no longer demand the circuit from AT&T for the remaining five years of the commitment term. However, if the competitor ceases purchasing the circuit from AT&T, it would face a substantial early termination penalty.

Incumbent LECs understand that, if competitors wish to serve a large number of retail customers, they cannot afford to incur such penalties on a regular basis. Thus, incumbent LECs offer competitors an alternative "solution"—purchase arrangements under which the incumbent LEC will not impose early termination penalties so long as the competitor commits to maintaining a certain volume of circuits in service with the incumbent LEC. This "benefit" is known as "circuit portability." Often, the volume commitment that a competitor must make in order to receive this benefit is equal to a high percentage of the competitor's historic special access purchase volume from the incumbent LEC.

For example, in legacy Southwestern Bell and Pacific Bell territories, AT&T provides purchasers the option of subscribing to a "portability commitment" under its Term Payment Plan ("TPP").[45] If a purchaser selects this option, it may freely connect and disconnect individual circuits without incurring early termination penalties, so long as it commits to maintaining at least 80 percent of its historic purchase volume in service with AT&T for a period of three

[45] *See* Southwestern Bell Tariff F.C.C. No. 73 § 7.2.22(E). AT&T's "portability commitment" is offered as an optional component of AT&T's term-based plan in these territories (the Term Payment Plan), whereas Verizon's Commitment Discount Plan, discussed below, is offered as a plan that is distinct from Verizon's term-based plan in legacy Bell Atlantic and NYNEX territories (the Term Pricing Plan). Despite this formalistic difference, both arrangements present competitors with a similar choice.

years.[46] Similarly, in legacy Bell Atlantic and NYNEX territories, Verizon provides purchasers the option of purchasing services pursuant to the Commitment Discount Plan ("CDP"),[47] under which a purchaser may freely connect and disconnect individual circuits without incurring early termination penalties,[48] so long as the purchaser commits to maintaining at least 90 percent of its historic purchase volume in service with Verizon for a period between two and seven years.[49]

Incumbent LEC purchase arrangements that condition circuit portability on large volume commitments thus present competitors with a Hobson's choice—either incur frequent and substantial early termination penalties or agree to purchase a large proportion of special access demand from the incumbent LEC. If they wish to serve a large number of retail customers, competitors must often select the latter option. Unsurprisingly, incumbent LECs derive a very

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[46] *See id.*

[47] *See* Verizon Telephone Companies Tariff F.C.C. No. 1 § 25.1.4.

[48] Circuit portability under the CDP is limited by a one-year minimum in-service period. *Id.* § 25.1.10.

[49] *See* Verizon Telephone Companies Tariff F.C.C. No. 1 § 25.1.4(D). Customers receive more favorable discounts if they agree to maintain this purchase volume for a longer period of time. According to Verizon, **[BEGIN HIGHLY CONFIDENTIAL]** [redacted] **[END HIGHLY CONFIDENTIAL]** *See* Letter from Maggie McCready, Vice President, Federal Regulatory Affairs, Verizon, to Marlene H. Dortch, Secretary, FCC, WC Docket No. 05-25 *et al.*, at 2 (filed June 6, 2012) ("*Verizon June 6, 2012 Letter*"). Other incumbent LEC exclusionary purchase arrangements contain percentage-based volume commitments that are even more onerous than these. For example, under CenturyLink's Regional Commitment Plan ("RCP"), a customer must commit to maintaining 95 percent of its special access purchase volume in service in order to receive discounted rates and circuit portability. *See* Qwest Corporation Tariff F.C.C. No. 1 § 7.1.3(B). In addition, some incumbent LEC exclusionary purchase arrangements allow the customer to determine its own commitment level. *See, e.g.*, BellSouth Telecommunications Tariff F.C.C. No. 1 § 2.4.8(B). Under these exclusionary purchase arrangements, incumbent LECs induce customers to establish high volume commitment levels by only granting circuit portability and other benefits to the volume of circuits committed.

large portion of their special access revenues from these plans. For example, in 2010, Verizon derived more than **[BEGIN HIGHLY CONFIDENTIAL]** [redacted] **[END HIGHLY CONFIDENTIAL]** from the sale of DS1s and DS3s under tariff discount plans with volume commitments, amounting to over **[BEGIN HIGHLY CONFIDENTIAL]** [redacted] **[END HIGHLY CONFIDENTIAL]** of its revenue from the sale of DS1s and DS3s nationwide.[50] This massive volume, and the massive volumes committed under the other incumbent LECs' exclusionary purchase arrangements, are effectively locked out of the addressable market for any existing or potential alternative provider of wholesale special access services.

This is so because, once a competitor agrees to a volume commitment with the incumbent LEC, it is virtually impossible for the competitor to shift any of its committed special access demand to an alternative provider. Incumbent LECs impose substantial shortfall penalties if a customer's actual purchase volume falls short of its committed volume. For example, under AT&T's TPP portability commitment, if a customer were to shift more than 20 percent of its DS1 purchases from AT&T to an alternative provider during the current term and thus fall short of its 80 percent commitment level, AT&T would charge the customer a monthly penalty of $900 for each circuit by which the customer's purchase volume fell short.[51] According to NRRI,

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[50] *See* **[BEGIN HIGHLY CONFIDENTIAL]** [redacted] **[END HIGHLY CONFIDENTIAL]** Verizon derives over **[BEGIN HIGHLY CONFIDENTIAL]** [redacted] **[END HIGHLY CONFIDENTIAL]** annually from the sale of DS1s and DS3s under the CDP alone. *See Verizon June 6 Letter* at 2-3.

[51] *See* Southwestern Bell Tariff FCC No. 73 § 7.2.22(E)(4)(b) (indicating that the monthly shortfall penalty is equal to the nonrecurring channel termination charge for each circuit by which the customer falls short), § 7.3.10(F)(5) (indicating that the nonrecurring channel termination charge is equal to $900); Pacific Bell Telephone Company Tariff F.C.C. No. 1 § 7.4.18(E)(4)(b) (indicating that the monthly shortfall penalty is equal to the nonrecurring channel

this penalty "amounts to six times the price at which a buyer could purchase the same circuit at rack prices."[52] Under Verizon's CDP, if a customer were to shift more than 10 percent of its DS1 or DS3 purchases from Verizon to an alternative provider during the plan's term, and thus fall short of its 90 percent commitment level, the customer would nonetheless be required to pay Verizon for its full commitment level volume.[53]

To make matters worse, incumbent LECs impose overage penalties if a customer exceeds a *maximum* purchase volume level, unless the competitor agrees to ratchet up its volume commitment to encompass the overage. For example, under the AT&T TPP portability commitment, AT&T imposes a $900 monthly overage penalty for each circuit a competitor purchases in excess of 124 percent of a competitor's commitment level unless the competitor increases its commitment level to encompass the overage.[54]

In addition, incumbent LECs impose substantial penalties if a competitor seeks to reduce its volume commitment or cancel its volume commitment altogether during its commitment term. For example, under AT&T's TPP portability commitment, AT&T charges the customer a

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termination charge for each circuit by which the customer falls short), § 7.5.9(I)(5) (indicating that the nonrecurring channel termination charge is equal to $900).

[52] *NRRI Study* at 74.

[53] *See* Verizon Telephone Companies F.C.C. Tariff No. 1 § 25.1.7(B); Verizon Telephone Companies F.C.C. Tariff No. 11 §§ 25.1.7(B). CenturyLink imposes a similar shortfall penalty under the RCP. *See* Qwest Tariff F.C.C. No. 1 § 7.1.3(B)(3).

[54] *See* Pacific Bell Telephone Company Tariff F.C.C. No. 1 § 7.4.18(E)(4)(c); Southwestern Bell Tariff FCC No. 73 § 7.2.22(E)(4)(c). Under the Verizon CDP, Verizon charges the customer the undiscounted rate for each circuit in excess of 130 percent of the customer's commitment level unless the customer increases its commitment level to encompass the overage. *See* Verizon Telephone Companies F.C.C. Tariff No. 1 § 25.1.7(D).

penalty equal to the undiscounted MRC for each service by which the customer reduces its volume commitment for the remainder of the three-year term.[55]

Incumbent LECs have argued that competitors can simply shift all or a subset of their purchases to an alternative wholesale provider at the end of an incumbent LEC purchase arrangement's term,[56] but this is rarely, if ever, a realistic option. To begin with, it is not possible for a competitor that serves a large number of business customers to shift *all* of its special access purchases in a given incumbent LEC territory to an alternative wholesale provider because, as explained in Section II.A *supra*, alternative wholesale providers currently own facilities serving only a very small number of commercial buildings. Any suggestion that an alternative wholesale provider would be able to construct new facilities to every location served by the competitor seeking to shift its purchases from the incumbent LEC disregards the high barriers to deploying last-mile facilities.[57] At best, a competitor could only attempt to shift a subset (likely a small subset) of its demand to an alternative wholesale provider and keep the remaining portion of its demand in service with the incumbent LEC under a new purchase arrangement. However, because of the manner in which incumbent LECs have structured the terms of their purchase arrangements, competitors face significant obstacles to accomplishing such a transition. The volume commitments required under incumbent LEC purchase

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[55] *See* Southwestern Bell Telephone Company, Tariff F.C.C. No. 73, § 7.2.22(E)(4)(e). Under Verizon's CDP, Verizon applies a more complicated formula, but Verizon's formula often yields very large early termination penalties as well. *See* Verizon Telephone Companies F.C.C. Tariff No. 1 § 25.1.9(C).

[56] *See, e.g.*, Letter from Evan T. Leo, Counsel for Verizon, to Marlene H. Dortch, Secretary, FCC, WC Docket No. 05-25 *et al.*, at 4 (filed July 16, 2012) ("*Verizon July 16, 2012 Letter*") ("When a customer's plan expires, the customer has many options, including migrating all of its circuits away from Verizon.").

[57] *See* Section II.A *supra.*

arrangements are based on either a percentage of the competitor's total purchase volume from the incumbent LEC at the time the competitor signs up for the purchase arrangement, or its total purchase volume from the incumbent LEC in the month before it signs up for the purchase arrangement.[58] Thus, in order to sign up for a new purchase arrangement at a lower volume commitment level, the competitor must have already begun purchasing a subset of its special access volume from an alternative wholesale provider. Of course, if the competitor attempted to do so during the term of its original purchase arrangement, it would incur extremely high shortfall penalties and early termination penalties, as explained above.

Thus, a competitor could only attempt to undergo such a transition after the expiration of its original purchase arrangement and before it signs up for a new one. As tw telecom has explained, if the transition involved any significant number of retail customers, this would be an extremely long and burdensome process.[59] Among other things, the competitor would be required to coordinate with *each* of its affected retail customers individually to schedule a mutually agreeable time at which its service can be interrupted and the necessary network modifications performed, dispatch service representatives to *each* of its affected retail customers' premises to establish a new network interface, and coordinate with third-party private branch

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[58] For example, under the CDP, a competitor's minimum volume commitment is equal to 90 percent of its purchase volume from Verizon at the time that the competitor signs up for the CDP. *See* Verizon Telephone Companies Tariff F.C.C. No. 1 § 25.1.3(A)(5). Under AT&T's TPP portability commitment, a competitor's minimum volume commitment is equal to 80 percent of its purchase volume from AT&T in the month previous to the month in which the competitor signs up for the portability commitment. *See* Southwestern Bell Tariff F.C.C. No. 73 § 7.2.22(E).

[59] *See* Letter from Thomas Jones and Matthew Jones, Counsel for tw telecom, to Marlene H. Dortch, Secretary, FCC, WC Docket No. 05-25 *et al.*, at 7-8 (filed Aug. 21, 2012) ("*tw telecom August 21, 2012 Letter*").

exchange vendors where necessary to perform further equipment modifications.[60] Throughout this process, the competitor would be required to operate without the discounts and other benefits (such as circuit portability) associated with the purchase arrangement for every special access service that the competitor purchases from the incumbent LEC in the relevant territory. The cost of foregoing such discounts and benefits across a large volume of special access circuits is likely to be prohibitive.

Finally, under some exclusionary purchase arrangements, competitors remain subject to early termination penalties associated with individual circuit terms *even after the expiration of a volume commitment*. For example, under AT&T's TPP portability commitment, once the three year volume commitment expires, each circuit remains subject to its own term commitment of up to seven years.[61] Therefore, in addition to undergoing the transition process described above, a competitor would be required to incur early termination fees on the circuits it wishes to transfer to an alternative provider to the extent that the terms of those circuits have not expired. The cost of those early termination fees would almost certainly be prohibitive.

2. Incumbent LEC Exclusionary Purchase Arrangements Tie the Sale of Services That Are or Might Be Subject to Competitive Supply to the Sale of Services That Are Not Subject to Competitive Supply.

Exclusionary purchase arrangements also act as tying arrangements by requiring purchasers to purchase services that are or might be subject to competitive supply from the incumbent LEC in order to receive discounts or other benefits on services that are not subject to

[60] For this reason, Verizon's suggestion that a competitor could undergo such a transition during a two-month "grace period" offered by Verizon is wildly unrealistic. *See id.*

[61] *See* Southwestern Bell Tariff F.C.C. No. 73 § 7.2.22(E) (indicating that DS1 TPP terms of 2, 3, 4, or 7 years count toward the volume commitment level, which itself applies to periods of three years at a time).

competitive supply. This allows incumbent LECs to leverage their dominance in the provision of certain DS1 and DS3 special access services in order to gain or maintain market share in the provision of services that might otherwise be subject to more competition. The incumbent LECs achieve this result in three distinct ways.

First, by requiring a competitor to maintain a very high purchase volume across a large territory, such as an entire legacy BOC territory, incumbent LECs leverage their dominance in the parts of that territory that are not subject to competition in order to gain or maintain market share in the parts that might be subject to competition. For example, while the level of density in New York City may offer an alternative wholesale provider a legitimate business case to construct its own facilities in certain locations, the level of density in many parts of upstate New York likely does not. For many buildings in upstate New York, a competitor seeking to purchase a DS1 or DS3 special access service has only one choice—purchasing from Verizon. However, in order for Verizon to grant the competitor circuit portability for these services, the competitor must subscribe to the CDP, which, as described above, requires the customer to maintain 90 percent of its historic purchase volume across legacy NYNEX territory.[62] Thus, the competitor must forego the opportunity to purchase services from an alternative wholesale provider, even in New York City, in order to obtain these benefits.

Second, by inducing competitors to agree to volume commitments that encompass both special access rate elements that might be subject to competition and non-competitive special access rate elements, incumbent LECs leverage their dominance in the provision of non-competitive special access rate elements in order to gain or maintain market share in the provision of special access rate elements that might be subject to competition. For example, in

[62] *See* Verizon Telephone Companies Tariff F.C.C. No. 1 § 25.1.

some geographic areas in the legacy Qwest territory, the market for transport may be subject to more competition than the market for channel terminations. However, in order to receive circuit portability for channel terminations in the legacy Qwest territory, a competitor must subscribe to CenturyLink's RCP. That plan requires the competitor to maintain 95 percent of its historic purchase volume as measured in revenues, including revenues from both the purchase of channel terminations and the purchase of transport.[63] Thus, in order to obtain a discount on channel terminations, the competitor must continue to purchase both channel termination and transport circuits from CenturyLink. In so doing, the competitor foregoes the opportunity to purchase transport from alternative wholesale providers in the legacy Qwest territory even where such providers might have already deployed facilities or might decide to enter.

Third, by inducing competitors to agree to volume commitments that encompass both special access services over which the incumbent LEC has market power and non-special access services that are subject to competition, incumbent LECs leverage their dominance in the provision of special access services in order to gain or maintain market share in the provision of competitive non-special access services. For example, **[BEGIN HIGHLY CONFIDENTIAL]** [redacted] **[END HIGHLY CONFIDENTIAL]** Agreements such as

[63] *See* Qwest Corporation Tariff F.C.C. No. 1 § 7.1.3(B).

this require competitors to forego the opportunity to purchase non-special access services from alternative wholesale providers where doing so would otherwise be economical.[64]

3. Incumbent LEC Exclusionary Purchase Arrangements Harm Competition and Consumer Welfare.

By forcing competitors to purchase virtually all of their special access service needs from incumbent LECs and tying special access services that might be subject to competition to the purchase of special access services that are not subject to any competition, the incumbent LECs prevent alternative providers from entering into or expanding their presence in the special access market. As Drs. Besen and Mitchell explain, the loyalty and tying effects yield higher rates for special access services in a number of ways. *First*, demand for incumbent LEC services becomes less elastic, giving incumbent LECs the incentive and ability to increase special access rates without the threat of losing sales to competitors.[65] *Second*, competitors are denied economies of scale, thus raising their costs and requiring them to price their services higher.[66] *Third*, competitors may reduce their investment in research and development (for example, by reducing investment in research personnel or network planning activity) because they anticipate that future sales will not be adequate to justify such investments. This eliminates future cost savings that could have otherwise resulted from such research and development and makes entry less likely.[67]

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[64] If a competitor declines to enter into such an agreement with an incumbent LEC, it risks placing itself at a competitive disadvantage with respect to other competitors that do enter into such an agreement. For this reason, as explained in Section II.D *infra*, the Joint Commenters propose that the FCC prohibit agreements of this nature.

[65] *See Besen and Mitchell Paper* ¶ 34.

[66] *See id.* ¶¶ 35-37.

[67] *See id.* ¶ 38.

In addition, where incumbent LECs tie the sale of non-special access services that are subject to competition to the sale of special access services that are not subject to competition, incumbent LECs harm competition in the non-special access service markets. Thus, the harmful effects of the incumbent LEC exclusionary purchase arrangements extend beyond even the critically important markets for special access services.

4. Incumbent LEC Exclusionary Purchase Arrangements Do Not Have Countervailing Efficiency Justifications.

Incumbent LECs have often claimed that there are countervailing efficiency justifications associated with the anticompetitive loyalty and tying provisions in their exclusionary purchase arrangements, but these claims are false. *First*, incumbent LECs assert that volume commitment provisions yield efficiencies associated with "greater certainty and predictability."[68] However, under many exclusionary purchase arrangements, circuit portability and other benefits are conditioned on a competitor committing to maintain a certain *percentage* of its historic purchase volume in service with the incumbent LEC, rather than a certain *number* of circuits. As Drs. Besen and Mitchell explain, "To the extent that there are economies of scale in the provision of special access, those economies are more likely to depend on the *number* of circuits purchased by a customer than on the *percentage* of the customer's historic purchases that these circuits represent."[69]

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[68] *See, e.g.*, *Verizon July 16, 2012 Letter* at 3-4.

[69] *Besen and Mitchell Paper* ¶ 41; *see also tw telecom August 21, 2012 Letter* at 2-4 (rebutting Verizon's assertions regarding purported efficiencies yielded by the percentage-based volume commitment provisions in its CDP and its National Discount Plan).

Second, incumbent LECs claim that volume commitment provisions offer them economies of scale.[70] But these commitment provisions nearly always encompass purchases across an extremely broad geographic area. For example, in order to receive circuit portability from AT&T in either North Carolina or Florida, a customer must agree to the Area Commitment Plan, which contains a volume commitment that applies throughout legacy BellSouth territory, including both of these states.[71] According to Drs. Besen and Mitchell, "It is highly unlikely, to say the least, that an ILEC's costs in providing special access to a particular customer in one of its service areas are affected to any significant degree by the amount of special access services that it provides to that customer in another area."[72]

Third, incumbent LECs argue that "volume discount plans are easier to manage and administer and allow providers to avoid the expense of constantly renegotiating the terms of service."[73] But this ease of management and administration is entirely unrelated to the volume commitments in incumbent LEC purchase arrangements. As Drs. Besen and Mitchell point out, with the exception of non-tariffed commercial agreements, incumbent LECs' DS1 and DS3 special access offerings are set forth in their tariffs, and the terms of these tariffs govern special access sales whether a competitor chooses to purchase services under a purchase arrangement with a volume commitment or not.[74] The incumbent LECs' claim that, without a large volume

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[70] *See, e.g.*, Declaration of Quinn Lew and Anthony Recine on Behalf of Verizon, ¶ 28 (dated Feb. 24, 2010) (attached as Attachment B to Reply Comments of Verizon, WC Docket No. 05-25 *et al.* (filed Mar. 19, 2010)) ("*Lew and Recine Declaration*").

[71] *See* BellSouth Telecommunications Tariff F.C.C. No. 1 § 2.4.8(B).

[72] *Besen and Mitchell Paper* ¶ 42; *see also id.* ¶ 46.

[73] *Lew and Recine Declaration* ¶ 28.

[74] *See Besen and Mitchell Paper* ¶ 45.

commitment, they would have to "constantly renegotiate" the terms of their tariffed special access offerings is therefore not credible.

Fourth, incumbent LECs defend their volume commitment provisions because they claim that they "have allowed [incumbent LECs] to make … substantial capital investments with some certainty that [their] investments will be recovered through special access revenues."[75] Again, this purported benefit does not justify conditioning benefits on the percentage of a competitor's historic purchase volume that it agrees to maintain in service with the incumbent LEC. As Drs. Besen and Mitchell explain, "if a customer were to purchase a smaller percentage of its requirements from [the incumbent LEC], presumably [the incumbent LEC] would make smaller special access investments and would be able to recover the costs of those investments from the proceeds of special access purchases that are actually made by the customer."[76]

5. Antitrust Precedent Supports the Conclusion that Incumbent LEC Exclusionary Purchase Arrangements Are Anticompetitive and Harm Consumer Welfare.

Agencies and courts have assessed contract provisions that are similar to the loyalty and tying terms and conditions in incumbent LEC purchase arrangements, and have found that such provisions violate the antitrust laws. This precedent supports the conclusion that incumbent LEC purchase arrangements are anticompetitive and harm consumer welfare.

First, the Federal Trade Commission ("FTC") has brought enforcement actions against companies that offer discounts or other benefits conditioned on the proportion of a customer's requirements for a product or service that it purchases from the company. For example, in 2009, the FTC filed a complaint against Intel alleging that Intel had violated Section 5 of the Federal

[75] *Lew and Recine Declaration* ¶ 28.

[76] *Besen and Mitchell Paper* ¶ 47.

Trade Commission Act[77] by, among other things, conditioning discounts and other benefits on a buyer's commitment to purchase a large share of its microprocessor requirements from Intel.[78] In its Complaint, the FTC alleged that Intel possessed monopoly power since its market share exceeded 75 percent and Intel's competitors faced significant barriers to entry.[79] It further alleged that "Intel offered market share or volume discounts selectively to [original equipment manufacturers ("OEMs")] to foreclose competition."[80] The FTC explained that "[i]n most cases, it did not make economic sense for any OEM to reject Intel's exclusionary pricing offers."[81] Thus, OEMs almost always accepted, and "Intel's offers had the practical effect of foreclosing rivals from all or substantially all of the purchases by an OEM."[82] To resolve these allegations,

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[77] 15 U.S.C. § 45.

[78] *See* Administrative Complaint, *In the Matter of Intel Corporation*, FTC Docket No. 9341 (Dec. 16, 2009) ("*FTC Complaint*"), *available at* http://www.ftc.gov/os/adjpro/d9341/091216intelcmpt.pdf. For a discussion of the FTC's case against Intel, *see* J. Farrell, J.K. Pappalardo, and H. Shelanski, Economics at the FTC: Mergers, Dominant-Firm Conduct, and Consumer Behavior, *Review of Industrial Organization*, 8-9 (Oct. 30, 2010), *available at* http://www.ftc.gov/be/otherdocuments/econatftc/Farrelletal_RIO2010.pdf. The FTC's allegations were similar to those made in a private antitrust suit filed by AMD in 2005. *See* Complaint, *Advanced Micro Devices, Inc. v. Intel Corporation.*, Docket Nos. MDL 05-17174JF, Civ. A. 05-441-JJF (D. Del. June 27, 2005). In order to settle the dispute with AMD, Intel agreed to pay AMD $1.25 billion and adhere to a set of conditions, including a commitment not to induce customers to exclusively purchase microprocessors from Intel. *See* S. Shankland and J. Skillings, *Intel to Pay AMD $1.25 Billion in Antitrust Settlement*, CNET (Nov. 12, 2009), *available at* http://news.cnet.com/8301-1001_3-10396188-92.html (last visited Feb, 11, 2013).

[79] *FTC Complaint* ¶¶ 41-46.

[80] *FTC Complaint* ¶ 7; *see also id.* ¶ 53 ("Intel offered market share or volume discounts selectively to OEMs to foreclose competition in the relevant CPU markets. . . . Intel taxed OEM purchases of non-Intel CPUs through the use of market share discounts.").

[81] *Id.* ¶ 7.

[82] *Id.*

Intel entered into a consent decree with the FTC that prohibited it from, among other things, entering into any purchase arrangement that conditioned a discount or benefit on the share of a customer's requirements for microprocessors that the customer purchased from Intel rather than its competitors.[83]

Second, courts have analyzed contracts that effectively require a customer to purchase a large proportion of its requirements from a given seller as *de facto* forcing the customer to purchase only from the seller. For example, in *ZF Meritor v. Eaton*, the Third Circuit Court of Appeals found that a manufacturer of truck transmissions entered into *de facto* exclusive dealings contracts when it conditioned discounts on a customer meeting purchase volume thresholds that ranged from 70 to 97.5 percent of the customer's requirements.[84] The Court explained that such agreements can have adverse economic consequences similar to those of explicit exclusive dealings contracts (e.g., "allowing one supplier of goods or services unreasonably to deprive other suppliers of a market for their goods.")[85] The Court found that, "although the market-share targets covered less than 100% of the OEMs' needs, a jury could

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[83] Decision and Order, *In the Matter of Intel Corporation*, FTC Docket No. 9341, § IV.A.5 (Oct. 29, 2010), *available at* http://www.ftc.gov/os/adjpro/d9341/100804inteldo.pdf. In a similar case, Transitions Optical entered into a consent decree with the FTC in which it agreed, among other things, to refrain from "offering market share discounts that are based on what percentage of a customer's photochromic lens sales are Transitions' lenses." *See* FTC Bars Transitions Optical, Inc. from Using Anticompetitive Tactics to Maintain its Monopoly in Darkening Treatments for Eyeglass Lenses (Mar. 3, 2010), *available at* http://www.ftc.gov/opa/2010/03/optical.shtm (last visited Feb. 11, 2013).

[84] *ZF Meritor, LLC v. Eaton Corp.*, 696 F.3d 254, 265 (3d Cir. 2012).

[85] *Id.* at 270 (citing *Jefferson Parish Hosp. Dist. No. 2 v. Hyde,* 466 U.S. 2, 45 (1984) (O'Connor, J., concurring); *Barry Wright Corp. v. ITT Grinnell Corp.*, 724 F.2d 227, 236 (1st Cir. 1983) ("[U]nder certain circumstances[,] foreclosure might discourage sellers from entering, or seeking to sell in, a market at all, thereby reducing the amount of competition that would otherwise be available").

nevertheless find that the [agreements] unlawfully foreclosed competition in a substantial share of the . . . market."[86] Thus, it affirmed the jury's verdict that the agreements were anticompetitive and caused the manufacturer's competitor to suffer antitrust injury.[87]

Third, courts have analyzed bundled discounts that require a customer to purchase both a monopoly good and a competitive good in order to receive a discount on the monopoly good as tying arrangements.[88] For example, in *Lepage's v. 3M,* the Third Circuit held that 3M illegally leveraged its dominance in the market for transparent tape (afforded by its Scotch tape brand) to induce stores to purchase other 3M product lines that were subject to competitive supply.[89] 3M accomplished this leveraging by providing a discount on Scotch tape only if a store bought certain volumes of its other product lines that were subject to competition.[90] Similarly, in

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[86] *ZF Meritor*, 696 F.3d at 283.

[87] *See id.* at 303 ("[W]e conclude that Plaintiffs presented sufficient evidence to support the jury's finding that Eaton engaged in anticompetitive conduct and that Plaintiffs suffered antitrust injury as a result"); *see also Masimo Corp. v. Tyco Health Care Group, L.P.*, 350 Fed. App'x 95 (9th Cir. 2009) (affirming a jury verdict that Tyco's agreements containing discounts conditioned on a hospital purchasing 90 percent of its requirements for pulse oximetry products from Tyco constituted anticompetitive *de facto* exclusive dealings contracts).

[88] For an explanation of such discounts, *see* Phillip Areeda & Herbert Hovenkamp, Antitrust Law ¶ 749, at 83 (Supp. 2002)) ("The anticompetitive feature of package discounting is the strong incentive it gives buyers to take increasing amounts or even all of a product in order to take advantage of a discount aggregated across multiple products. In the anticompetitive case, which we presume is in the minority, the defendant rewards the customer for buying its product *B* rather than the plaintiff's *B*, not because defendant's *B* is better or even cheaper. Rather, the customer buys the defendant's *B* in order to receive a greater discount on *A*, which the plaintiff does not produce. In that case the rival can compete in *B* only by giving the customer a price that compensates it for the foregone *A* discount.").

[89] *See Lepage's Inc. v. 3M,* 324 F.3d 141 (3d Cir. 2003).

[90] *Id.* at 155 ("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.").

SmithKline v. Eli Lilly, the Third Circuit found that Lilly violated Section 2 of the Sherman Act by conditioning a discount for two antibiotics, over which it had a monopoly, on a hospital purchasing quantities of a third antibiotic that was subject to competition from SmithKline.[91] In order to match the discount provided on all three antibiotics by Lilly, SmithKline would have to sell the competitive antibiotic at uneconomically low prices, and thus was effectively excluded from the market.[92]

The tying and loyalty provisions at issue in these cases bear a close resemblance to the tying and loyalty provisions in incumbent LECs' exclusionary special access purchase arrangements. Just as the courts and regulatory agencies have found that these kinds of provisions violate antitrust laws, the Commission should conclude that they are unreasonable in violation of Section 201(b) of the Communications Act.

C. Incumbent LEC Exclusionary Purchase Arrangements Undermine the Policy Goals of Section 706.

Section 706 of the 1996 Act directs the Commission to "encourage the deployment on a reasonable and timely basis of advanced telecommunications capability to all Americans . . . ."[93] The anticompetitive terms and conditions in incumbent LEC special access purchase arrangements blatantly undermine this policy goal.

First, as described above, competitors must effectively purchase a large proportion of their special access volume from the incumbent LEC, thereby limiting their ability to purchase

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[91] *See SmithKline Corp. v. Eli Lilly & Co.*, 575 F.2d 1056, 1060-61 & n.3 (3d Cir. 1978).

[92] *See id.* at 1065 ("The effect of the [discount plan] was to force SmithKline to pay rebates on one product, Ancef, equal to rebates paid by Lilly based on volume sales of three products. . . . [T]he court found SmithKline's prospects for continuing in the cephalosporin market under these conditions to be poor.").

[93] 47 U.S.C. § 1302(a).

material volumes of special access services from alternative wholesale providers without incurring significant penalties. As a result of this limitation, there is a far smaller addressable market for existing or potential alternative wholesale providers than would otherwise be the case. Thus, such providers have a reduced incentive to deploy last-mile fiber facilities to commercial buildings. For example, as Level 3 has explained, it would construct fiber facilities to many more buildings that are near its network if incumbent LEC purchase arrangements did not hinder it from doing so. However, Level 3 has a reduced incentive to incur the expense to construct such facilities because its prospective wholesale customers would be unable to purchase more than a small fraction of their requirements from Level 3.[94]

Second, by effectively requiring competitors to continue purchasing large volumes of DS1 and DS3 special access services, incumbent LEC exclusionary purchase arrangements delay the adoption of Ethernet and other packet-mode services. As tw telecom and Level 3 have explained, incumbent LEC purchase arrangements lack sufficiently flexible technology migration provisions, thereby limiting competitors' ability to upgrade DSn services to Ethernet services.[95] For example, under the terms of many exclusionary purchase arrangements, if a

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[94] *See* Letter from Michael J. Mooney, Counsel for Level 3, to Marlene H. Dortch, Secretary, FCC, WC Docket No. 05-25 *et al.*, at 5 (filed June 27, 2012) ("Level 3 would construct fiber to many more buildings that are near its network, if AT&T's (and the other price cap LECs') lock up arrangements did not hinder it from doing so. Level 3 is forced to sit out more often than it would like not because it wants to, but because if it did incur the expense to build to these buildings, its prospective, large customers would be unable to buy more than a fraction of their demand from Level 3 as they are already locked in to buying from AT&T and the other price cap LECs instead.").

[95] *See* Letter from Thomas Jones & Matthew Jones, Counsel for tw telecom, to Marlene H. Dortch, Secretary, FCC, WC Docket No. 05-25 *et al.*, at 13 (filed June 5, 2012) (explaining that the absence of sufficiently flexible technology migration provisions in incumbent LEC tariffs limit tw telecom's ability to upgrade DSn services to Ethernet services); *tw telecom April 11, 2012 Letter* at 20-22 (describing how various incumbent LEC exclusionary purchase arrangements impose shortfall penalties that prevent customers from upgrading DSn services to

competitor were to cease purchasing the incumbent LEC's DS1 and DS3 special access services at certain of the competitor's retail customer locations and begin purchasing the incumbent LEC's Ethernet services to these locations instead, the customer would incur significant shortfall penalties.[96] The result is that, **[BEGIN HIGHLY CONFIDENTIAL]** [redacted] **[END HIGHLY CONFIDENTIAL]**

D. The Commission Should Take Several Steps Now to Address the Harm Caused by Incumbent LEC Exclusionary Purchase Arrangements.

The Commission can and should take action now to begin to diminish the harmful effects of incumbent LEC exclusionary purchase arrangements. By adopting the targeted rules prescribed by Drs. Besen and Mitchell and described in this section, the Commission can begin

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Ethernet services); *Level 3 February 22, 2012 Letter* at 21 (explaining that the upgrade provisions in Verizon's tariffs do not allow Level 3 to upgrade DSn services to Ethernet services without incurring early termination fees, and that the technology migration provisions in those tariffs are subject to a number of restrictions that limit their utility (*e.g.*, length of commitment requirements, bandwidth requirements, revenue test requirements, terminating location requirements, timing requirements, and notification requirements)).

[96] This is so because these incumbent LEC exclusionary purchase arrangements do not count Ethernet purchases toward a competitor's volume commitment. *See tw telecom April 11, 2012 Letter* at 20-22.

[97] **[BEGIN HIGHLY CONFIDENTIAL]** [redacted] **[END HIGHLY CONFIDENTIAL]** The fact that incumbent LEC exclusionary purchase arrangements effectively require this result directly undermines AT&T's specious narrative that it wishes to accelerate the transition to packet-mode technologies while competitors somehow wish to slow this transition down. *See, e.g.*, Letter from Robert W. Quinn, Jr., Senior Vice President, Federal Regulatory and Chief Privacy Officer, AT&T Services, Inc., to Marlene H. Dortch, Secretary, FCC, WC Docket No. 05-25 *et al.*, at 2 (filed Jan. 14, 2013) (asserting that competitors are attempting to "*slow down*" the transition to a packet-mode environment and preserve their purportedly "TDM-based business plans" for "as long as possible") (emphasis in original).

to encourage real competition in the special access market while at the same time ensuring that incumbent LECs retain the ability to recover their costs, earn a reasonable return on their investments, and offer their customers a wide variety of pricing options.[98]

First, Drs. Besen and Mitchell recommend that the Commission adopt Level 3's proposal to limit the size of the volume commitment that an incumbent LEC may require as a condition of providing a discount or other benefit, such as circuit portability.[99] The limit for such commitments should be set at a level that would allow purchasers to shift a material amount of their special access purchases to alternative wholesale providers without incurring substantial penalties.[100] Similarly, the Commission should prohibit incumbent LECs from imposing any penalty if a purchaser declines to increase its volume commitment to encompass growth in the purchaser's special access demand. In addition, the Commission should prohibit incumbent LECs from conditioning the availability of a discount or other benefit, such as circuit portability, on a purchaser's commitment to purchase non-special access services. According to Drs. Besen

[98] Despite the inevitable protestations to the contrary, if the Commission were to adopt these proposals, incumbent LECs would continue to have significant flexibility in pricing their services. For example, they would continue to be able to de-average their rates under existing FCC rules, enabling them to establish up to seven pricing zones that they alone define. *See* 47 C.F.R. § 69.123(b). In addition, they would continue to be able to offer discount arrangements, so long as they comply with the limits described herein. The Commission should not, however, allow the incumbent LECs to exploit this flexibility to override the Commission's reforms by reducing discounts and raising prices. *See* note 101 *infra.*

[99] *See Level 3 February 22, 2012 Letter* at 28.

[100] For example, if a competitor currently purchases services under Verizon's CDP, it may only shift 10 percent of its historic purchase volume away from Verizon to an alternative wholesale provider without incurring a penalty. *See* Verizon Telephone Companies Tariff F.C.C. No. 1 § 25.1.4(D) (requiring a purchaser to maintain at least 90 percent of its historic purchase volume in service with Verizon). However, if Verizon were only permitted to require a customer to commit to maintaining 50 percent of its historic purchase volume in service, the customer would have the ability to shift up to 50 percent of its purchases to alternative wholesale providers.

and Mitchell, such measures would expand the addressable market for alternative wholesale providers and allow them to compete more effectively.[101]

Second, Drs. Besen and Mitchell recommend that the Commission adopt rules that prevent incumbent LECs from using the recovery of customer-specific sunk costs as a means of engaging in anticompetitive conduct. As Drs. Besen and Mitchell explain, nonrecurring charges ("NRCs") and term commitments with early termination penalties are presumably justified as a means of recovering customer-specific, sunk costs associated with providing a circuit.[102] However, incumbent LECs often exploit these mechanisms to prevent competitors from purchasing services from an alternative wholesale provider. For example, as described in Section III.B *supra*, incumbent LECs often impose excessive NRCs and offer to waive these fees only if the customer commits to purchase the circuit for a committed term. In addition, if a customer ceases purchasing a circuit prior to the expiration of its committed term, incumbent LECs often impose early termination penalties that far exceed any customer-specific sunk costs.

In order to prevent these abuses, Drs. Besen and Mitchell recommend that the Commission permit an incumbent LEC to impose a mandatory NRC for a special access service *only* if such a charge is no higher than the incumbent LEC's customer-specific sunk costs of

[101] *See Besen and Mitchell Paper* ¶ 50. If the Commission adopts these proposals, it must ensure that incumbent LECs do not simply override the Commission's action by eliminating the discounts and benefits that they offer special access purchasers today. For example, the Commission should require Verizon to continue offering the discounted rates and circuit portability that it currently offers under the CDP once the volume commitment provision in the CDP has been modified. In addition, in order to ensure that incumbent LECs are not able to circumvent these measures, the Commission should prohibit incumbent LECs from entering into contract tariffs that condition discounts or benefits on a dollar- or quantity-based volume commitment that is effectively larger than the maximum percentage-based commitment permitted under this rule.

[102] *See id.* ¶¶ 56-57.

providing the service. One way the Commission could determine a reasonable proxy for such a charge would be to evaluate the NRCs currently charged by incumbent LECs in each of their service areas. For instance, if an incumbent LEC currently charges an NRC of $200 in one of its service areas for a DS1 channel termination, that NRC would likely be sufficient to cover any customer-specific, sunk costs associated with providing a DS1 channel termination in any incumbent LEC territory. Alternatively, the Commission could use the cost-based NRC applicable to the sale of a DS1 as an unbundled network element as a benchmark for the sale of a DS1 as a special access service. If an incumbent LEC does not wish to be limited to the rate determined by one of these benchmarking techniques, the Commission could allow the incumbent LEC an opportunity to make a forward-looking, cost-based showing of its customer-specific sunk costs in order to determine a more appropriate NRC limit.

Similarly, Drs. Besen and Mitchell state that the Commission should permit an incumbent LEC to set a commitment term for the purchase of a special access service *only* if (1) the duration of the term is no longer than needed to recover any unrecovered customer-specific sunk costs of providing the service; (2) the penalty for early termination is no higher than any unrecovered customer-specific sunk costs of providing the service; and (3) the rate for recovering any unrecovered customer-specific sunk costs of the circuit is charged independently, so as to create transparency for cost recovery. Thus, incumbent LECs would not be permitted to impose NRCs and early termination penalties that, in the aggregate, exceed the customer-specific sunk costs associated with providing a circuit. In addition, the Commission should require that incumbent LECs give purchasers an option of covering these costs with an NRC to be imposed when the special access service is initiated. As Drs. Besen and Mitchell explain, these measures