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wholesale prices charged by other incumbent LECs and by competitors, and with the retail prices charged by incumbent LECs and competitors for these services. Discounted rates charged for Ethernet and packet-mode services in situations where multiple competitors offer facilities-based services may also offer a helpful benchmark for reasonable Ethernet and packet-mode special access prices. The Commission should be particularly focused on identifying circumstances in which incumbent LECs have sought to place competitors in a price squeeze by charging wholesale prices for Ethernet and other packet-mode special access services above the level of retail prices for those services or services that utilize those special access services as inputs.<sup>170</sup>

These price benchmarks will enable the Commission to determine the extent to which incumbent LECs are exploiting their market power to charge unreasonable prices for DS1 and DS3 services in areas subject to Phase II pricing flexibility and for Ethernet and other packet-mode services throughout their territories. They will also enable the Commission to assess the extent to which price caps effectively constrain incumbent LEC rates for DS1 and DS3 services, something the Commission has committed to do ever since the expiration of the CALLS Plan in 2005.<sup>171</sup>

Finally, the Commission should also assess the extent to which incumbent LECs have begun to impose unreasonable terms and conditions on wholesale purchasers of Ethernet and

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<sup>170</sup> See, e.g., Letter from Jonathan Lechter, Counsel for tw telecom, to Marlene H. Dortch, Secretary, FCC, GN Docket Nos. 09-51 *et al.*, at 8 & Appendix (filed Dec. 22, 2009).

<sup>171</sup> See *Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Low-Volume Long-Distance Users; Federal-State Joint Board On Universal Service*, Sixth Report and Order in CC Docket Nos. 96-262 and 94-1, Report and Order in CC Docket No. 99-249, Eleventh Report and Order in CC Docket No. 96-45, 15 FCC Rcd 12962, ¶ 166 (2000) (“*CALLS Order*”) (“[A]fter the five-year term we can re-examine the issue to determine whether competition has emerged to constrain rates effectively.”); *id.* ¶ (“[T]he rates will remain at the target rates until July 1, 2005, at which time the Commission will reexamine them.”); see also *In the Matter of Special Access Rates for Price Cap Local Exchange Carriers*, Order and Notice of Proposed Rulemaking, 20 FCC Rcd. 1994, ¶¶ 2, 24-68 (2005) (“*2005 Special Access NPRM*”).

other packet-mode special access services. For example, the Commission should be alert to unreasonable restrictions on the services that a wholesale customer may provide via Ethernet and packet-mode special access services purchased from incumbent LECs. Such conduct could be extremely harmful to competition and consumer welfare across the economy.

**5. *Applying Panel Regressions to Relevant Special Access Markets***

In theory, the Commission could use panel regression analysis *in lieu* of applying the market power framework to identify the relevant special access markets in which incumbent LECs have and are currently exercising market power. For example, the Commission might be able to use panel regressions to identify the circumstances in which competition disciplines incumbent LEC prices (e.g., in circumstances where three or more facilities-based competitors serve a particular location, incumbent LEC DS3 prices on average decline by 20 percent) and the circumstances in which they do not. If this is the case, the Commission could establish a means of aggregating the relevant product and geographic markets in which competition does not discipline incumbent LEC prices. It could then tailor new pricing regulation to those circumstances. This analysis might obviate the need for the Commission to separately measure market shares, demand elasticity, and supply elasticity.

However, in order to conduct reliable panel regressions to measure actual competition, the Commission would need to account for several key factors. *First*, as explained, the Commission should not consider firms that provide services via facilities leased from the incumbent LEC to be market participants for purposes of assessing incumbent LEC market power. Again, there are numerous reasons for this, among them that the UNEs upon which many competitive carriers rely are being eliminated and are subject to important limitations. Nevertheless, competitors that rely on these facilities likely have some disciplining effect on

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incumbent LEC special access prices. The Commission would need to “back out” the effect of these competitors when it conducts the panel regressions. Otherwise, the market for special access services is likely to appear more competitive than is in fact the case.

*Second*, as explained in Section II.B *supra*, loyalty and tying provisions in the incumbent LEC exclusionary purchase arrangements prevent special access customers from switching to non-incumbent LEC wholesale providers even in the limited circumstances in which those competitors offer service via their own facilities. These arrangements also diminish the extent to which competitors are willing to expand their network facilities into new geographic areas. Taken together, the effects on demand and supply appear to reduce an incumbent LEC’s firm elasticity of demand below the level that would otherwise exist. Thus, it could be that incumbent LECs would be forced by competition to lower special access prices in certain situations in the absence of the existing exclusionary purchase arrangements. It is not obvious how the Commission would be able to account for this fact in conducting panel regressions.

*Third*, panel regressions would be most informative if the incumbent LECs generally change their special access prices materially depending on the circumstances, but this does not appear to be their practice. At least in the case of DS1 and DS3 services, incumbent LECs do not appear to modify their prices based on the number of competitors that offer service in the relevant area. Rather, incumbent LECs generally charge the same DS1 and DS3 prices across a large region (e.g., a price “band” or “zone” within a legacy operating company region). Where the incumbent LECs do offer lower prices for DS1 and DS3 services as part of an individually negotiated contract tariff or commercial agreement, it appears that the reductions are less a response to the number of competitors than a *quid pro quo* for some non-price benefit that the incumbent receives as part of the agreement (e.g., the customer’s agreement not to purchase

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UNEs or the customer's agreement to purchase non-special access services from the incumbent). Moreover, it could well be that the incumbent LECs price their Ethernet and other packet-mode special access services in a similar, largely uniform manner (this appears to be especially likely in the case of wholesale Ethernet special access).

Uniform prices across an incumbent LEC's territory would make it difficult to rely on panel regressions to support reliable conclusions about the extent to which incumbent LECs are subject to competition in the special access market. It is possible, indeed likely, that the competitors function as "fringe" competitors in almost all relevant markets and therefore have no ability to cause incumbent LECs to lower prices to a significant number of customers in any market. In order to make that assessment, the Commission would need to conduct an analysis similar to the one it performs under the established market power framework.

**B. There is No Reliable Basis for the Commission to Predict That Significant Competitive Entry Will Occur in Any Relevant Special Access Market.**

In addition to assessing the extent to which incumbent LECs are subject to actual competition in the provision of special access services, the Commission states in the *Further NPRM* that it plans to assess the level of potential competition in the provision of special access services.<sup>172</sup> It apparently plans to do this by relying on the market power framework, supplemented by panel regressions.

As explained below, however, neither recent history nor current market conditions offers any basis for predicting the circumstances in which entry might occur in the future in special access product markets that are today dominated by incumbent LECs. To be sure, competitors will continue to try to build local transmission facilities to serve locations where customers

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<sup>172</sup> See *Further NPRM* ¶ 67.

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demand very high capacity circuits (e.g., OCn and high-capacity Ethernet) that yield sufficient revenues to justify the deployment of new transmission facilities. But there is no basis for concluding that DSn or mid- and low-capacity Ethernet services, which generally do not yield sufficient revenues to justify the deployment of new transmission facilities, will somehow become subject to increased competition in the foreseeable future.

Accordingly, instead of expending scarce administrative resources on trying to predict circumstances in which competitive entry will occur, the Commission should focus on removing the significant obstacles to entry created by incumbent LEC exclusionary purchase arrangements as described by Drs. Besen and Mitchell and on establishing appropriate rate regulation in relevant product markets in which incumbent LECs have market power as described above. After the protections against incumbent LEC exclusionary purchase arrangements have been in place for a period of time, the Commission can reassess the level of competition to determine the extent to which it is necessary to retain regulation in relevant special access product markets.

***1. Applying the Market Power Framework to Measure Potential Competition in Relevant Special Access Markets***

Under the market power framework, the Commission considers future entry to be relevant only if it is timely, likely and of sufficient scale to counteract the exercise of market power by an incumbent LEC.<sup>173</sup> It is simply not plausible that any firm or group of prospective entrants could meet this standard.

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<sup>173</sup> See *Phoenix Order* ¶ 41; see also *Merger Guidelines* § 9. Under this standard, it is necessary to examine barriers to entry such as high capital expenditures, large sunk costs, long lead times, scale economies, and cost disadvantages. See, e.g., U.S. Department of Justice & Federal Trade Commission, *Commentary on the Horizontal Merger Guidelines*, at 38 (Mar. 2006), available at <http://www.usdoj.gov/atr/public/guidelines/215247.pdf>; ABA Section of Antitrust Law Developments, at 351 (6th ed. 2007).

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To begin with, the barriers to deploying local transmission facilities have not materially changed over time. As explained in Section II.A *supra*, and as the FCC itself has held, these barriers remain extremely high.<sup>174</sup> Moreover, as also explained in Section II.B *supra*, incumbent LEC special access exclusionary purchase arrangements effectively lock up a large percentage of the market, thereby significantly increasing the barriers to future entry. These factors alone undermine any confidence in predictions of future entry in markets in which incumbent LECs currently have market power.

It is also highly relevant that the Commission has a long history of incorrectly predicting that competition would develop in the provision of the dedicated transmission services that incumbent LECs offer as special access. In 1997, in anticipation that the regime created by the 1996 Act and implemented in the *Local Competition Order* would generate robust competition in local markets “over the next few years,” the Commission announced its intention to rely on competition rather than regulation as the predominant means of ensuring that incumbents LECs price their special access services in an economically efficient manner.<sup>175</sup> Unfortunately, the Commission’s predictions about competitive entry have proven overly optimistic, leaving incumbent LECs largely unrestrained in their ability to exercise market power.

For example, the FCC premised the structure of the CALLS plan on the expectation that competition would begin to discipline incumbent LEC special access rates during the term of the

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<sup>174</sup> See *Phoenix Order* ¶ 84 (finding that competitive carriers continue to “face extensive economic barriers to the construct of last-mile facilities”); *id.* ¶ 90 (same).

<sup>175</sup> *In the Matter of Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Transport Rate Structure and Pricing; End User Common Line Charges*, First Report and Order, 12 FCC Rcd. 15982, ¶¶ 262-284 (1997), *aff’d*, *Southwestern Bell Tel. Co. v. FCC*, 153 F.3d 523 (8th Cir. 1998).

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plan.<sup>176</sup> In addition, the Commission predicted that competition would be sufficiently robust by 2005 to eliminate the need for further mandated rate reductions.<sup>177</sup> Specifically, the Commission predicted that, in order to compete with “competitors utilizing a range of technologies, including cable, cellular, MMDS and LMDS,” incumbent LECs would effectively be required to share their productivity gains with consumers by reducing their rates.<sup>178</sup> Of course, the extent of competitive entry between 2000 and 2005 was far smaller than the Commission expected. Thus, when it initiated the special access rulemaking proceeding in 2005, the Commission recognized the need for an alternative mechanism to restrain incumbent LEC rates.<sup>179</sup>

Similarly, in granting Qwest relief from its Section 251(c)(3) unbundling obligations in the Omaha MSA, the Commission predicted that sufficient competition would develop to ensure that Qwest would offer wholesale DS0, DS1, and DS3 loops on reasonable terms and conditions.<sup>180</sup> However, subsequent events in the post-forbearance Omaha market made clear

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<sup>176</sup> See *CALLS Order* ¶ 166 (“[W]e believe that increased competition will serve to constrain access rates in the later years of the CALLS Proposal as X-factor reductions are phased out. We believe that market forces, instead of regulatory prescription, should be used to constrain prices whenever possible.”).

<sup>177</sup> *Id.*

<sup>178</sup> *Id.*

<sup>179</sup> *2005 Special Access NPRM* ¶ 131 (“This record contains substantial evidence suggesting that productivity has increased and continues to increase in the provision of special access services. Under the CALLS plan, however, there is currently no productivity factor in place to require price cap LECs to share any of their productivity gains with end users. Accordingly, we anticipate adopting an order prior to July 1, 2005 that will establish an interim plan to ensure special access price cap rates remain just and reasonable while the Commission considers the record in this proceeding.”). Of course, the Commission never adopted such an interim plan.

<sup>180</sup> *In the Matter of Petition of Qwest Corporation for Forbearance Pursuant to 47 U.S.C. § 160(c) in the Omaha Metropolitan Statistical Area*, Memorandum Opinion and Order, 20 FCC Rcd. 19415, ¶¶ 79-83 (2005) (“*Omaha Order*”).

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that this prediction was incorrect. Qwest failed to offer reasonable wholesale pricing, causing one major competitor to exit the Omaha market and causing at least one major competitor to abandon its decision to enter that market.<sup>181</sup> This series of events led the Commission to acknowledge that its predictions in the *Omaha Forbearance Order* “[had] not been borne out by subsequent developments.”<sup>182</sup>

Furthermore, predictions regarding the *manner* of competitive entry in the market for special access services have been proven to be unreliable as well. In the *Pricing Flexibility Order*, the FCC determined that incumbent LEC special access offerings would be subject to effective competition in each market in which competitive “triggers” were satisfied.<sup>183</sup> However, when the Commission recently suspended operation of these triggers, it found that its central predictions regarding both the nature and the scope of competitive entry were not supported by subsequent evidence. The Commission determined that evidence had called into question its predictions that competitors that established fiber-based collocations would construct last-mile facilities and that competitive entry occurs at the MSA level.<sup>184</sup>

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<sup>181</sup> *Phoenix Order* ¶ 34.

<sup>182</sup> *Id.*

<sup>183</sup> *Access Charge Reform; Price Cap Performance for Local Exchange Carriers; Interexchange Carrier Purchases of Switched Access Services Offered by Competitive Local Exchange Carriers; Petition of U.S. West Communications, Inc. for Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA, Fifth Report and Order and Further Notice of Proposed Rulemaking*, 14 FCC Rcd. 14221 (1999) (“*Pricing Flexibility Order*”), *aff’d WorldCom v. FCC*, 238 F.3d 449 (D.C. Cir. 2001).

<sup>184</sup> *See Pricing Flexibility Suspension Order* ¶ 68 (“Evidence submitted to the Commission since 1999 calls into question the Commission’s prediction that collocators would eventually build their own channel terminations to end users.”); *id.* at ¶ 35 (“The record in this proceeding suggests that, contrary to the Commission’s prediction in 1999, MSAs have generally failed to reflect the scope of competitive entry. Rather, in many instances, the scope of competitive entry has apparently been far smaller than predicted.”)

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There is no reason to think that the Commission would be any more accurate in predicting future entry now than has been the case in the past. Accordingly, there is no basis for the Commission to have any confidence that it could reliably identify firms or groups of firms whose future entry would be timely, likely, and of sufficient scale to counteract incumbent LEC exercise of market power in a relevant special access market.

**2. *Applying Panel Regression Analysis to Measure Potential Competition in Relevant Special Access Markets***

In the *Further NPRM*, the Commission suggests that it could use panel regression analysis to “predict where and how potential competition will occur.”<sup>185</sup> But it would be extremely difficult for the Commission to develop a set of panel regressions that reliably predict future entry into product markets in which the incumbent LECs currently possess market power. To begin with, the discussion of such an analysis in the *Further NPRM* makes no mention of the significant effect of incumbent LEC exclusionary purchase arrangements discussed in Section II.B *supra*. Again, incumbent LEC exclusionary purchase arrangements dramatically limit the opportunities for competitive wholesale providers to enter the market for special access services. Thus, the Commission must make sure to account for the effect of these arrangements when seeking to predict where entry might occur in the future.

Unfortunately, accounting for the effect of incumbent LEC exclusionary purchase arrangements poses numerous challenges. To begin with, as the incumbent LECs have themselves asserted, a large portion of DS1 and DS3 special access services purchased from incumbent LECs are subject to the incumbent LEC purchase arrangements.<sup>186</sup> Given that these

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<sup>185</sup> See *Further NPRM* ¶ 68.

<sup>186</sup> See *supra* note 50 and accompanying text.

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arrangements cover a large percentage of the special access services sold throughout the country, it may be very difficult for the Commission to compare the level of entry in areas subject to loyalty and tying arrangements with the level of entry in areas not subject to those arrangements.

As explained in Section II.B *supra*, the details of incumbent LEC exclusionary purchase arrangements vary significantly. In fact, many incumbent LECs offer several different types of generally available special access discount plans in each territory. In addition, in areas subject to Phase I and Phase II pricing flexibility, incumbent LECs enter into individually negotiated contract tariffs in which special access customers receive additional discounts on top of those available in the generally available plans in return for making additional commitments. As a result, special access customers in each incumbent LEC region are often subject to a wide range of different purchase arrangements. This makes the task of accounting for the effect of the loyalty and tying components of these arrangements complex.

Moreover, notwithstanding the complexity and diversity of the incumbent LEC exclusionary purchase arrangements, there is no single purchase arrangement that stands out as obviously less exclusionary than the others. Thus, even if the Commission could compare levels of entry in circumstances where different incumbent LEC purchase arrangements apply, it is not clear that such a comparison would yield the conclusion that entry is more likely under one type of purchase arrangement than another.

The Commission would also face other challenges in seeking to rely on panel regressions to predict future entry. The barriers to deploying local transmission facilities vary significantly from building-to-building, from point-to-point route to point-to-point route, and from municipality to municipality. These variations are due, among other things, to differences in the building access policies of multi-tenant building owners, differences in the rates, terms and

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conditions offered by utilities for obtaining access to utility-owned poles, ducts and conduits, different rates, terms and conditions offered by municipalities for obtaining access to public rights of way, different labor costs, and different levels of congestion in different areas. It would be extremely complex and difficult to account for these differences when seeking to predict future entry into any particular special access market.

In light of these factors, it appears that panel regressions are unlikely to offer a reliable means of predicting that competitive entry will occur into special access markets in which incumbent LECs current possess market power. Even attempting to account for all of the factors that affect entry would require a significant allocation of Commission resources. Accordingly, the Commission should instead focus its panel regression analysis on assessing circumstances in which incumbent LECs face actual competition in relevant markets. As to potential competition, the Commission should forego making any predictions about future entry and instead focus on removing the entry barriers caused by incumbent LEC exclusionary purchase arrangements. The Commission can then assess the level of competition at a future date, after the protections against these arrangements have been in place for long enough to have an effect on the marketplace.

IV. CONCLUSION

For the foregoing reasons, the Commission should take the actions recommended herein by the Joint Commenters.

Respectfully submitted,

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# **APPENDIX A**

**Anticompetitive Provisions of ILEC Special Access Arrangements**

Stanley M. Besen and Bridger M. Mitchell

February 11, 2013

Table of Contents

<b>I.</b>	<b>Qualifications.....</b>	<b>2</b>
<b>II.</b>	<b>tw telecom Continues To Be Dependent on ILECs for Special Access .....</b>	<b>3</b>
<b>III.</b>	<b>The Effect of ILEC Loyalty Contracts on Special Access Competition .....</b>	<b>6</b>
<b>IV.</b>	<b>How Loyalty Contracts Work.....</b>	<b>9</b>
<b>V.</b>	<b>Examples of Loyalty Provisions in ILEC Special Access Contracts .....</b>	<b>14</b>
<b>VI.</b>	<b>How ILEC Loyalty Contracts Lead to Higher Special Access Rates.....</b>	<b>20</b>
<b>VII.</b>	<b>Many ILEC Loyalty Provisions Do Not Have Efficiency Justifications .....</b>	<b>23</b>
<b>VIII.</b>	<b>Remedies to Encourage Competitive Supply of Special Access.....</b>	<b>28</b>

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**I. Qualifications**

1. My name is Stanley M. Besen. I have published widely on telecommunications economics and policy, intellectual property, and the economics of standards and have consulted to many companies in the telecommunications and information industries. I have served as a Brookings Economic Policy Fellow, Office of Telecommunications Policy, Executive Office of the President (1971-72); Co-Director, Network Inquiry Special Staff, Federal Communications Commission (1978-80); Coeditor, RAND Journal of Economics (1985-88); Senior Economist, RAND Corporation (1980-92); a member of the Editorial Board of Information Economics and Policy (1992-2004); and Vice President, Charles River Associates (1992-2008). I currently serve as a member of the Editorial Board of Economics of Innovation and New Technology. I have taught at Rice University (1965-1980), where I was the Allyn R. and Gladys M. Cline Professor of Economics and Finance, Columbia University (1988-1989) where I was the Visiting Henley Professor of Law and Business, and the Georgetown University Law Center (1990-1991) where I was Visiting Professor of Law and Economics. I hold a Ph.D. in Economics from Yale University (1964). My CV is attached hereto as Attachment 1.

2. My name is Bridger M. Mitchell. I am an expert in competition and pricing in the telecommunications industry and have provided expert testimony, litigation support, and economic consulting services to numerous business and government clients. My research on major regulatory issues encompasses the theory and practice of telecommunications pricing, competition, and equal access in local telephone markets, interconnection in telecommunications networks, international telephone rates, and broadcasting and cable television. I have developed pioneering models of the cost structure of a cable television firm and the incremental costs of local telephone networks. I taught economics at Stanford University, as Assistant Professor of Economics from 1966 to 1971

and as Acting Associate Professor of Economics in 1976, and at UCLA from 1973–1975 as Lecturer in Economics. From 1972–1994, I served as Senior Economist, RAND Corporation. From 1994 to 2008 I was a Vice President of Charles River Associates and thereafter have been a Senior Consultant to the firm. I hold a Ph.D. in Economics from the Massachusetts Institute of Technology. My CV is attached hereto as Attachment 2.

**II. tw telecom Continues To Be Dependent on ILECs for Special Access**

3. We have been retained by tw telecom to address the effects on competition of various provisions in the arrangements under which tw telecom purchases special access services from Incumbent Local Exchange Carriers (“ILECs”). tw telecom purchases special access services from ILECs through both tariffed discount plans and non-tariffed commercial agreements. In this Declaration we generally use the term “contracts” to apply to both types of arrangements. Although our focus is primarily on tw telecom, our analysis is applicable to other companies that purchase special access services under similar arrangements.

4. Although tw telecom has constructed facilities to approximately 17,000 buildings in the United States, and builds facilities to approximately 1,500 additional buildings each year, it must still purchase special access facilities from another carrier to reach customers at [BEGIN HIGHLY CONFIDENTIAL] [END HIGHLY CONFIDENTIAL] of the approximately [BEGIN HIGHLY CONFIDENTIAL] [END HIGHLY CONFIDENTIAL] buildings that it currently serves.<sup>1</sup> Moreover, except in very rare instances, tw telecom would have to purchase these facilities from another carrier in order to serve customers at any buildings that it

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<sup>1</sup> Letter from Thomas Jones and Matthew Jones, Counsel to tw telecom, to Marlene H. Dortch, Secretary, FCC, WC Docket No. 05-25 *et al.*, at 11-12 (filed Aug. 21, 2012) (“*tw telecom August 21 Letter*”).

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currently does not serve.<sup>2</sup>

5. Not only must tw telecom purchase special access services from another carrier at the vast majority of the buildings that it serves or is likely to serve in the future, the ILECs are often the only carriers that have facilities that reach most of these buildings. As tw telecom has noted, “...ILECs control the only last mile facilities serving the vast majority of business customer locations for which tw telecom must purchase services from a wholesale provider.”<sup>3</sup> For example, tw telecom analyzed the extent of competitive deployment in the Phoenix Metropolitan Statistical Area (“MSA”) and found that, based on the information available to tw telecom, the ILEC controls the only last mile connection to more than [BEGIN HIGHLY CONFIDENTIAL] [END HIGHLY CONFIDENTIAL] percent of commercial buildings in that MSA.<sup>4</sup> This should come as no surprise to the Commission, which observed in the *Data Request Order* that the available evidence suggests that “competitive providers may serve a relatively small proportion of all locations that have special access.”<sup>5</sup>

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<sup>2</sup>According to tw telecom, it has been able to deploy its own loop facilities to an average of only [BEGIN HIGHLY CONFIDENTIAL] [END HIGHLY CONFIDENTIAL] percent of customer locations with demand for two or more DS1s in Atlanta, Los Angeles, Phoenix, Seattle, and Washington DC as of March 2012. See tw telecom Build/Buy Analysis at 1 (attached as Appendix C to Comments of BT Americas, Cbeyond, EarthLink, Integra, Level 3 and tw telecom, WC Docket No. 05-25 *et al.* (filed Feb. 11, 2013) (hereinafter referred to as “*Comments*”). Moreover, tw telecom has estimated that it would be viable in the future to deploy its own loop facilities to only about [BEGIN HIGHLY CONFIDENTIAL] [END HIGHLY CONFIDENTIAL] percent of the buildings that it currently does not serve in these cities. See *id.* at 4.

<sup>3</sup> See Letter from Thomas Jones and Matthew Jones, Counsel to tw telecom, to Marlene H. Dortch, Secretary, FCC, WC Docket No. 05-25 *et al.*, at 4 (filed June 5, 2012).

<sup>4</sup> See *Comments* at 18-19 & Appendix B.

<sup>5</sup> *Special Access for Price Cap Local Exchange Carriers; AT&T Corporation Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, Report and Order and Further Notice of Proposed Rulemaking, 27 FCC

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6. tw telecom’s continuing dependence on the ILECs is shown by the fact that tw telecom currently makes a very large share of its special access purchases from them. For example, in June 2012, more than [BEGIN HIGHLY CONFIDENTIAL] [END HIGHLY CONFIDENTIAL] percent of tw telecom’s expenditures on all channel termination services were for purchases from ILECs.<sup>6</sup> For DS1 services, which accounted for more than [BEGIN HIGHLY CONFIDENTIAL] [END HIGHLY CONFIDENTIAL] percent of the amount that tw telecom spent on purchases of all channel termination services, more than [BEGIN HIGHLY CONFIDENTIAL] [END HIGHLY CONFIDENTIAL] percent of tw telecom’s purchases were from ILECs.<sup>7</sup> Even for channel termination services that were provided using Ethernet technology, which accounted for less than [BEGIN HIGHLY CONFIDENTIAL] [END HIGHLY CONFIDENTIAL] percent of tw telecom’s expenditures on channel termination services, more than [BEGIN HIGHLY CONFIDENTIAL] [END HIGHLY CONFIDENTIAL] percent of tw telecom’s purchases were from ILECs.<sup>8</sup> Thus, although ILECs face competition from other suppliers of channel termination services at some locations, the vast majority of tw telecom’s purchases of channel termination services continue to be from the ILECs.

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Rcd. 16318, ¶ 25 (2012) (“*Data Request Order*”) (citation omitted). The Commission also noted that “competition in the provision of special access appears to occur at a very granular level – perhaps as low as building/tower or a floor of a building.” *Id.* ¶¶ 22, 38. Thus, even if there are competitive alternatives to the ILECs at some locations in a particular area, that does not necessarily mean that such alternatives exist at others locations in the same area.

<sup>6</sup> *See Comments* n.34.

<sup>7</sup> *See id.*

<sup>8</sup> *See id.*

**III. The Effect of ILEC Loyalty Contracts on Special Access Competition**

7. Although there are other potential suppliers of special access services, their ability to compete to provide services to tw telecom is severely limited by the ILECs' use of what we refer to in this Declaration as ILEC loyalty contracts, which can be implemented either through tariff provisions or the terms of commercial agreements. Although these contracts do not *explicitly* require tw telecom to make a very large percentage of its special access purchases from the ILECs, their *effect* is to condition discounts, or the avoidance of penalties,<sup>9</sup> on this percentage. Thus, they often amount to the same thing.<sup>10</sup>

8. As explained further below, the provisions in ILEC special access loyalty contracts take a number of forms. Some provisions provide rate discounts for a single circuit only if a customer commits to a *minimum contract term* for that circuit. Others condition circuit portability – the ability to terminate one special access circuit and replace it with another without incurring a termination penalty – on a customer's commitment to maintain a significant share of its historic purchase levels from the ILEC. Still others penalize a customer if it does not commit to increase its minimum volume commitment to the ILEC to include a large proportion of the *growth* in the customer's purchases from the ILEC. Many special access contracts contain a combination of these types of provisions.<sup>11</sup>

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<sup>9</sup> As discussed below, these penalties can involve an increase in the unit price, a fixed dollar payment, or a denial of benefits.

<sup>10</sup> Some writers, *e.g.*, Jonathan M. Jacobson, "A Note on Loyalty Discounts," *The Antitrust Source*, June 2010, treat loyalty and explicit market share discounts as equivalent, but we intend the term loyalty discounts to cover a wider range of behaviors.

<sup>11</sup> In addition, some ILEC contract provisions condition discounts, benefits, or the avoidance of penalties on the customer's commitment to purchase a minimum quantity of services other than special access channel termination or of services other than special access services (*i.e.*, either

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9. Moreover, there are practical limits to the ability of a special access customer to shift purchases to an ILEC rival even at the end of a contract term. For example, a customer that wishes to change suppliers would have to pay the ILEC's extremely high month-to-month rates until a competitive provider is able to supply the service and the customer can shift its customers to the new provider's facilities.<sup>12</sup>

10. Although the precise form of these loyalty provisions differ, all have the same intent and effect – to encourage customers of special access to purchase a very large share of their requirements from the ILEC – or, equivalently, to discourage these customers from purchasing a significant share of their special access requirements from ILEC rivals.

11. This basic conclusion has been reached by others who have analyzed competition in the market for special access services. For example, a study prepared for the National Regulatory Research Institute concluded that "...a combination of terms in discount plans may be allowing ILECs unreasonably to cement their market power by limiting the ability of buyers to shift special access circuits to competitors *who may have better products, lower prices, or both.*"<sup>13</sup> Similarly, the United States Government Accountability Office concluded that "These types of contracts 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 the competitor can meet the customer's entire demand, the

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channel terminations or mileage). Although we explain below that such provisions can be problematic, these are characterized more accurately as tying arrangements rather than loyalty provisions.

<sup>12</sup> See *Comments* at 28-30.

<sup>13</sup> P. Blum, National Regulatory Research Institute, *Competitive Issues in Special Access Markets*, Revised Edition, at 96 (first issued Jan. 21, 2009) (emphasis added).

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customer has an incentive to stay with the incumbent and 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.*”<sup>14</sup>

12. Moreover, as Joseph Farrell has pointed out, the fact that carriers such as tw telecom “freely” choose these restrictive long-term arrangements is simply an artifact of the very unattractive terms at which the ILECs offer month-to-month service. As he observed, “It is a tempting fallacy to think that optional discount plans cannot be harmful because consumers select them voluntarily. The claim that voluntary discounts cannot harm consumers assumes that basic month-to-month rates are not affected, but in fact, once 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 otherwise have chosen.”<sup>15</sup>

13. We also note here that, although the types of contracts that are offered by ILECs are similar to those that are offered in other, more competitive markets, this does not mean that their effects are benign. ILECs have large market shares and are much larger than their competitors. Moreover, potential entrants into the market for special access services face substantial barriers to entry. This almost certainly means that ILECs are the types of dominant firms for which the use of loyalty contracts are likely to be anticompetitive. As Patrick Greenlee and David Reitman have observed,

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<sup>14</sup> United States Government Accountability Office, FCC Needs to Improve Its Ability to Monitor and Determine the Extent of Competition in Dedicated Access Services, GAO-07-80, at 30 (Nov. 2006) (emphasis added).

<sup>15</sup> 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)) (“*Farrell Reply Declaration*”). The fact that a buyer “freely” accepts contract terms that restricts his ability to purchase special access terms from ILEC rivals is akin to the situation in which a robbery victim “freely” chooses to turn his money over to a thief after being offered the choice of “your money or your life”.

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“...purchase requirements, coupled with a loyalty discount for buyers who comply with the purchase terms, can function as exclusionary behavior to the detriment of rivals firms and competition. This is of particular concern *when the firm offering loyalty discounts is much larger than its rivals.*”<sup>16</sup> Similarly, as Fiona Scott-Morton has noted, “the settings where [such contracts] are most likely to harm consumers and competition involve *dominant firms possessing market power and a high market share.*”<sup>17</sup> Finally, even Hans Zenger, who believes that loyalty discounts are generally *not* anticompetitive, notes, “If a *dominant* firm is in a position to foreclose such a substantial part of the market that the output of the smaller competitors is suppressed below the minimum efficient scale of production, retroactive rebates can cause anticompetitive harm by jeopardizing the viability of the *dominant* firm’s competitors.”<sup>18</sup>

**IV. How Loyalty Contracts Work**

14. As many commentators have observed, contracts that require a customer to make a very large fraction of its purchases from one supplier in order to obtain a significant discount or avoid a significant penalty, effectively serve as a “tax” on purchases from competitors of that supplier. This occurs because, if a customer fails to meet its purchase commitment, it must pay a higher price for the units that it does purchase and the customer will take this increased price into account in

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<sup>16</sup> P. Greenlee & D. Reitman, *Competing with Loyalty Discounts*, U.S. Dep’t of Justice EAG Discussion Paper 04-02, at 2 (revised Jan. 7, 2006), *available at* <http://www.wcas.northwestern.edu/csio/Conferences/Papers2006/GreenleeandReitmanpaper.pdf>.

<sup>17</sup> F. Scott-Morton, *Contracts that Reference Rivals*, Presentation to Georgetown University Law Center, at 5 (Apr. 5, 2012) (emphasis added), *available at* [www.justice.gov/atr/public/speeches/281965.pdf](http://www.justice.gov/atr/public/speeches/281965.pdf).

<sup>18</sup> H. Zenger, *Loyalty Rebates and the Competitive Process*, JOURNAL OF COMPETITION LAW & ECON., at 33 (Mar. 2012) (citation omitted) (emphasis added), *available at* [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2019185](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2019185).

deciding whether to purchase from the competitor. This increase can take the form of a higher per-unit price on all units that the buyer continues to purchase, a fixed dollar penalty, the elimination of a benefit, or some combination of those.<sup>19</sup>

15. Even a small increase in price can represent a significant per-unit “tax” on purchases from the rival if the customer then continues to make a large share of its purchases from the dominant firm. Thus, although such contracts may contain no explicit prohibition on purchases from rivals, as is the case here, they can still prevent many such purchases. Under many of its contracts with ILECs, tw telecom must commit to maintaining a very high percentage – [BEGIN HIGHLY CONFIDENTIAL] [REDACTED] [END HIGHLY CONFIDENTIAL] – of its historic purchase levels from the ILEC in order to receive more favorable terms and conditions.<sup>20</sup>

Even under contracts that do not require such a commitment, tw telecom commits to a high

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<sup>19</sup> Greenlee and Reitman refer to the first type of contract as involving “dollar-one”, “all-unit”, or “rollback” discounts” and note that they “effectively increase the gain to a customer near the margin for meeting the target, relative to incremental discounts.” P. Greenlee and D. Reitman, *supra* note 16, at 5. As we note below, the effects of the penalties are the same whether they involve fixed dollar payments or rollbacks of previous discounts.

<sup>20</sup> See, e.g., [BEGIN HIGHLY CONFIDENTIAL] [REDACTED]

[REDACTED] [END HIGHLY CONFIDENTIAL] tw telecom is not the only carrier that makes a very large percentage of its special access purchases from ILECs. The National Regulatory Research Institute reported that over 90% of Verizon’s special access revenues from other carriers in 2009 were received under plans that contained discounts from the rack rates. See P. Blum, *supra* note 13, at 20.

percentage because the more favorable rates, terms, and conditions are available only for the purchases for which the commitment is made.<sup>21</sup> In either case, tw telecom would face a large “tax” if it were to shift even a relatively small amount of its purchases to an ILEC rival.

16. Not only do loyalty contracts induce customers to purchase a very large percentage of their requirements from the ILEC, at times they have induced a customer to purchase *more than* the number of special access circuits that it needs. For example, [BEGIN HIGHLY CONFIDENTIAL] [REDACTED] [END HIGHLY CONFIDENTIAL] has reported that it has occasionally purchased DS1 and DS3 “circuits to nowhere” in order to meet volume or revenue commitments and thereby avoid paying shortfall penalties that can be as much as ten times the monthly rate that [BEGIN HIGHLY CONFIDENTIAL] [REDACTED] [END HIGHLY CONFIDENTIAL] would otherwise pay for a circuit.<sup>22</sup> In addition to impeding entry of competitors, the purchase of unused circuits is clearly inefficient.

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<sup>21</sup> See, e.g., [BEGIN HIGHLY CONFIDENTIAL] [REDACTED] [END HIGHLY CONFIDENTIAL].

<sup>22</sup> See [BEGIN HIGHLY CONFIDENTIAL] [REDACTED] [END HIGHLY CONFIDENTIAL] Note that this implies that the price of the circuits that [BEGIN HIGHLY CONFIDENTIAL] [REDACTED] [END HIGHLY CONFIDENTIAL] purchases but does not use is *negative*. That is, the total cost of the larger purchase is actually *lower* than the total cost of the smaller purchase.

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17. If a customer shifts even a small percentage of business to an ILEC rival, ILEC loyalty contracts can impose a large “tax” or “penalty”. The result is that rival offerings are uncompetitive, ILEC market power is increased, and ILECs are able to raise prices.

18. The “tax” or “penalty” under a loyalty contract can take a number of different forms. It is easiest to illustrate the effect, however, by focusing on a contract that calls for an increase in the price of the units that a customer continues to purchase.<sup>23</sup> Under a so called “all-units”, “first-dollar”, or “rollback” discount plan, a buyer forfeits the per-unit discount on *all* of the units that it continues to purchase from the firm offering the loyalty discount (that is, the discount is “rolled back”) if its purchases from that firm fall below its purchase commitment.<sup>24</sup> Alternatively, or in addition, a buyer may be obligated to make a fixed dollar payment if it fails to meet the purchase requirement.

19. To see how the “tax” works, consider an “all-units” contract in which a customer that purchases 100 units of special access from all suppliers pays a price of \$10 per unit if it purchases 90 units from the dominant firm but \$11 per unit if it makes less than 90 percent of its purchases from that firm.<sup>25</sup> If the customer is purchasing 90 units from the dominant firm and shifts, say, 5 percent of its purchases to a competitor, say by renewing only 85 circuits at the conclusion of a contract, the total “tax” is the increase in price  $\$11 - \$10 = \$1$  (the “rollback” of the discount) on the units that it continues to purchase from the dominant firm times the number of units, 85, that it

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<sup>23</sup> We emphasize that, although tw telecom’s special access contracts with ILECs are not explicitly of this form, the effect of those contracts is the same as if they did have that form.

<sup>24</sup> For an example of this type of plan, *see* Declaration of Professor Einer Elhauge on Behalf of Eisai Inc. ¶ 3. *Eisai Inc. v. Sanofi-Adventis LLC*, No. 3:08 Civ. 4168 (D.N.J. Nov. 17, 2008).

<sup>25</sup> This example is illustrative of the effects of loyalty contacts on the incentives to purchase special access services from ILEC rivals. As we discuss below, the penalties in ILEC loyalty contracts take a wide variety of forms and are not limited to the type discussed in this example.