

**Before The  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C. 20554**

<b>In the Matter of</b>	)	
	)	
<b>Special Access Rates for Price Cap Local Exchange Carrier</b>	)	<b>WC Docket No. 05-25</b>
	)	
<b>AT&amp;T Corp. Petition for Rulemaking to Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services</b>	)	<b>RM-10593</b>
	)	

**REPLY COMMENTS OF COMPTTEL**

COMPTTEL hereby replies to certain arguments made by AT&T, Qwest and Verizon in their initial round of comments pursuant to the Commission’s Public Notice (“*Notice*”) released on November 5, 2009 (DA 09-2388) in the above-referenced dockets.

In our comments, COMPTTEL recommended that the Commission judge the reasonableness of special access prices by comparing the prices for these facilities/services to their underlying cost. The cost measure that COMPTTEL recommended was the TELRIC-price for the comparable facilities/network components that track special access.

In their comments, the incumbents suggest that any cost-based review of their special access rates would be misleading and inappropriate. It is understandable why these companies would seek to avoid *any* standard-based analysis that compared revenues/prices to cost, because they have not a single cost methodology that could be used to justify their prices as reasonable. Indeed the incumbents seem to acknowledge their unreasonably high profits, as they ineffectively try to justify them as necessary to provide incentive to implement cost efficiencies

and to attract capital. The desire to earn monopoly profits is understandable, but it comes at a substantial cost to the public interest. The urgent need for the pricing of special access to be reduced to reasonable levels, as explained in a number of comments, should guide the Commission's action in this matter.

AT&T and Qwest begin by generally attacking any price/cost analysis as being inconsistent with price-cap regulation. AT&T incredulously asserts that the "whole point" of price-cap regulation is higher profits for incumbents.<sup>1</sup> Higher profits may be a legitimate objective for the companies themselves, but ensuring such exorbitant profits is not the role of a government entity serving the public interest. The incumbents' high special access rates - despite gains in efficiencies - means consumers are not benefiting from these efficiencies and price-cap regulation has failed.

These incumbents argue, in particular, that a framework for analyzing price caps that focuses on "profits" would discourage the efficiency and innovation that price-cap regulation was intended to foster since, in their minds, the core feature of the regulatory framework was allowing incumbents to reap all the rewards of those efficiencies via higher profits.<sup>2</sup> While providing profit-driven incentive was a factor in the regulatory scheme, as COMPTTEL points out in the initial round of comments, the ultimate goal of the regulatory framework adopted by the Commission was to drive prices to forward-looking costs, i.e., consumers paying prices that reflect a more efficient network. While the Commission may have hoped that competition would

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<sup>1</sup> AT&T Comments at 63 ("...the whole point of price cap regulation was to provide LECs the opportunity to earn higher profits by becoming more efficient).

<sup>2</sup> See AT&T Comments at 50-55; See also Qwest Comments at 4 and 48 ("The *very point* of price cap and other incentive-based regulation is to give ILECs appropriate incentives to pursue high rates of return by cutting costs and increasing efficiencies. Penalizing ILECs now for earning "too high" a rate of return would subvert those very incentives.")(emphasis in original).

be successful enough to accomplish this objective, it recognized that further Commission action may be necessary.<sup>3</sup>

Moreover, the incumbents' argument that a profit analysis would frustrate the incentive to implement efficiencies (by allowing the efficiencies to "come back to haunt them" and "punish[ing] the most efficient carriers the most harshly for their efficiency gains")<sup>4</sup> are inapplicable to COMPTTEL's proposal. Such concerns would not arise if the Commission uses a price/cost ratio with the cost component reflecting rates generated from an accepted forward-looking cost model, as proposed by COMPTTEL. Without expressly acknowledging it, the incumbents themselves seem to recognize this by focusing their arguments on "[a]ttempts to reset price caps retrospectively based on *realized* profits or other *historical* market events" that in their mind "undermine the fundamental purpose of incentive regulation."<sup>5</sup>

Under COMPTTEL's proposal the incumbent prices would be judged against the same standard regardless of the efficiencies implemented. Since their implementation of available efficiencies would not impact the cost standard under which they'd be judge, they'd still have incentive to achieve greater efficiencies and, thereby, obtain greater profits. Indeed, the fact that the cost model under COMPTTEL's proposal has not been updated to incorporate the efficiencies of which the incumbents are so proud enables them to undercut the cost model to produce additional profits. In other words, the incumbents would still face an incentive to be more

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<sup>3</sup> *Special Access Rates for Price Cap Local Exchange Carriers*, WC Docket No. 05-25, *AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, RM-10593, Order and Notice of Proposed Rulemaking, FCC 05-18, ¶13 (2005)("Special Access NPRM") ("To the extent that competition did not fully achieve the goal of moving access rates toward costs, the Commission reserved the right to adjust rates in the future to bring them into line with forward looking costs.")

<sup>4</sup> AT&T Comments at 50 and 54.

<sup>5</sup> Carlton/Sider Declaration at ¶ 65 (emphasis added).

efficient and, at the same time, the standard or cap on the pricing of the services would be brought to a reasonable level.

Remarkably, AT&T's expert acknowledges that a comparison of price to marginal cost is "a standard way of defining market power."<sup>6</sup> Nonetheless, AT&T (ignoring the fact that only a company with substantial market power could set prices far above cost) goes on to argue that "in marketplaces characterized by high fixed and sunk costs with scale economies – like special access – firms must set prices well above typical measures of incremental cost to recover their large and risky investments, compensate investors for their risk, and to avoid bankruptcy."<sup>7</sup> Indeed, AT&T argues rate-of-return for special access today would need to be much higher than 11.25 percent because, they allege, special access is more competitive than in 1990 (again ignoring the improbability of a firm facing competition to set such high rates) and competition increases risks and additional risk requires firms to pay higher returns to attract capital from investors.<sup>8</sup> If this is true, it supports the notion that the development of competition is unlikely (it would be even harder to sustain the rates necessary to attract capital as a second or third entrant in such a risky market) as well as supports the need for the re-implementation of rate-of-return regulation in furtherance of the public interest, namely to reduce risk so that carriers can attract capital without charging exorbitant rates. Ironically, however, the claims for the need to

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<sup>6</sup> Carlton-Sider Declaration at ¶ 57. As discussed further in the comments, the price/cost analysis recommended by COMTEL does not judge rates in comparison to *marginal* cost, but instead uses the existing TELRIC price as a proxy for the Long Run Average Cost of the facilities at issue. Consequently, COMTEL's proposal would permit prices significantly above marginal cost and AT&T's discussion of the problems created by marginal cost pricing is little more than a distraction.

<sup>7</sup> AT&T Comments at 59-60.

<sup>8</sup> *Id.* at 66.

attract capital contradict AT&T's claim that they are no longer investing in "the legacy TDM and copper-based DSx services that are the focus of this proceeding."<sup>9</sup> Surely they are not suggesting that the Commission allow them to charge high rates on their regulated services to fund their unregulated services.

When AT&T and Verizon finally turn their discussion to specific critiques of various cost measures, they attack two principal costing approaches: forward-looking marginal costs, and accounting-based measures of average historic costs. Notably, the one measure they do not discuss (with the exception of a faulty legal argument discussed further below) is the Commission's TELRIC methodology, which is a forward-looking measure of average total cost structured to minimize (if not avoid) the very problems AT&T and Verizon raise.

To begin, AT&T makes the unsurprising observation that prices must exceed short-run marginal costs in order for a carrier to sustain operations.<sup>10</sup> As AT&T notes, this fact has been understood for a very long time – which is precisely why COMPTTEL has not suggested the approach. Short-run marginal costs represent the (relatively small) increase in cost experienced by an existing network to serve a small incremental increase in quantity demanded.<sup>11</sup> As such, if

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<sup>9</sup> AT&T Comments at 66-67.

<sup>10</sup> *See id.* at 59 ("Economists and the Commission have long understood that in marketplaces characterized by high fixed and sunk costs with scale economies – like special access – firms must set prices well above typical measures of incremental cost . . ."); *See also* Carlton-Sidler Declaration at ¶ 57 ("As a result of this cost structure the price for telecommunications services, including special access services, generally must exceed their short-run marginal cost in order for an LEC to sustain its operations.").

<sup>11</sup> As a practical matter, short-run marginal costs are always forward-looking in that the measure looks to estimate the cost of new facilities/inputs required to expand output. In this type of analysis, the costs of the established network (i.e., the embedded accounting cost of the existing plant) are not relevant to a short-run cost analysis because they cannot be causally attributed to an increase in sales.

all services were priced at their short-run marginal cost, the costs of the already existing facilities that enable the short-run marginal cost to be so low would go uncovered.

The alternative – as recommended by COMPTTEL – is to use a recognized measure of long-run average total cost to judge the reasonableness of special access prices. This methodology (TELRIC) was developed by the Commission – and implemented by the states over countless years of effort and analysis – to overcome exactly the concerns expressed by AT&T and Verizon with marginal costs,<sup>12</sup> while still avoiding the principle theoretical concerns of average costs.

There are three concerns expressed concerning average costs: (1) the magnitude of common costs that cannot be directly assigned to a particular service or application; (2) a concern with the administrative difficulty associated with cost-estimation (in any context); and (3) the particular problems associated with relying on historic accounting-costs to establish prices. The methodology recommended by COMPTTEL suffers from none of these flaws.

First, although both AT&T and Verizon point to the *theoretical* problems presented by common costs,<sup>13</sup> claiming that the telecommunication industry is unique with regard to the

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<sup>12</sup> Verizon’s position is difficult to discern in that Verizon both objects to any marginal cost analysis while criticizing average cost pricing because “*such cost allocations lead to prices that have no necessary relationship to marginal costs.*” Topper Declaration at ¶ 81 (emphasis in the original).

<sup>13</sup> See Carlton-Sidler Declaration at ¶ 58 (“If instead of using marginal costs, one uses some measure of average costs, one faces problems due to the multiproduct nature of telecommunications services . . . multiple services are jointly provided using LECs’ facilities and there is no theoretical basis for allocating common costs across services that is widely accepted among economists.”); See also Topper Declaration at ¶ 81 (“[G]iven economies of scope in costs, price-cost margins for individual services are likely to be uninformative about competitive conditions because of the arbitrary nature of common cost allocation.”).

magnitude of joint and common costs and the multi-service nature,<sup>14</sup> neither provides any analysis that there are any significant common costs associated with special access services that generally track specific network components such as loops and transport. Special access, like network elements, corresponds to distinct network facilities. When the Commission adopted the average total cost methodology known as TELRIC, it did so explicitly recognizing that determining the costs of specific network components would not give rise to significant common costs:

By contrast, the network elements, as we have defined them, largely correspond to distinct network facilities. Therefore, the amount of joint and common costs that must be allocated among separate offerings is likely to be much smaller using a TELRIC methodology rather than a TSLRIC approach that measures the costs of conventional services. Because it is difficult for regulators to determine an economically-optimal allocation of any such joint and common costs, we believe that pricing elements, defined as facilities with associated features and functions, is more reliable from the standpoint of economic efficiency than pricing services that use shared network facilities.<sup>15</sup>

The standard economic example of the intractable problems of common cost assignment is the local loop when used to provide long distance and local service. While it may be that it is economically impossible to “properly allocate” the cost of the local loop between these services, it is not impossible to determine the cost of the loop itself. The Commission’s TELRIC methodology was specifically developed to focus on network components – components that

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<sup>14</sup> AT&T Comments at 62 (“Today, however, the inherent arbitrariness of such an exercise would be an order of magnitude greater, given the nature of modern multi-service broadband networks.”); Qwest at 45 (“[T]hat allocation process is inherently arbitrary, because there is no definitive way to apportion common and shared costs among different services or between the interstate or intrastate portions of particular investments.”)

<sup>15</sup> *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98 *Interconnection Between Local Exchange Carriers and Commercial Mobile Radio Service Providers*, CC Docket No. 95-185, First Report and Order, FCC 96-325, ¶ 678 (1996)(“*First Report and Order*”).

track special access – in order to minimize any potential common cost issue. As AT&T explained at the time, the advantage of the approach is that “the vast majority of the relevant costs will be causally attributed to particular network elements.”<sup>16</sup> With few common costs to allocate, the principal objection to average cost pricing is rendered irrelevant.<sup>17</sup>

The second objection to average costs (and, presumably, any cost measure) is that attempts to analyze “LECs’ average costs of providing special access services would likely be complex and burdensome.”<sup>18</sup> COMPTTEL, however, is not recommending any such complex process, because the administrative cost of determining TELRIC measures have already been expended. The facts are easily developed – it is only how to *apply* the facts that is the issue.

Finally, Verizon seems to equate an average-cost analysis with historic accounting costs.<sup>19</sup> As we explained in our Comments (and repeat again here), the Commission’s TERLIC methodology is not based on accounting costs, but is based on the costs of (the then) current technologies available to ILECs in the late 1990s and early 2000s. Because these studies are now dated, using existing TELRIC prices as a proxy for economic cost will overstate the true economic costs (and thus advantage the ILEC). Despite this flaw, however, COMPTTEL recommends such costs be used to address the “administrative burden” issue raised by the ILECs.

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<sup>16</sup> *First Report and Order* at ¶ 645.

<sup>17</sup> The Department of Justice supported the view that focusing “on costs of facilities and network elements ... [will] reduce the amount of costs that must be treated as joint or common.” *Id.* at ¶ 644.

<sup>18</sup> Carlton-Sidler Declaration at ¶ 58.

<sup>19</sup> Topper Declaration at ¶¶ 82-83.

AT&T's *sole* argument directed specifically against the use of existing TELRIC rates in reinitializing special access rates is its fallacious claim that the D.C. Circuit, in *USTA II*, held that these rates are available only in circumstance where the Commission has made an impairment finding.<sup>20</sup> As an initial matter, as COMPTEL explains in its comments, using TELRIC rates as the cost factor in a price/cost ratio is not the same as re-pricing the services at TELRIC. So even if the Court had found as the incumbents claimed it did – which it did not – such a finding would not be dispositive of the matter at hand. Second, the Court did not restrict the Commission's use of TELRIC. It merely found that Section 271 (c)(2)(B)(ii) does not *require* that the Section 252(d)(1) pricing apply to Section 271 checklist items and that it is not unreasonable for the Commission to apply a different standard to 271 elements.<sup>21</sup> It did not find that the Commission *must* limit TELRIC to 251 unbundled network elements, i.e., conditions where impairment has been found.

Qwest and Verizon also make the outrageous claim that there is no dispute that special access prices are declining.<sup>22</sup> On the contrary, COMPTEL and others have repeatedly pointed to findings made by *independent sources* to counter these claims. In particular, in the phase II pricing flexibility areas, where the Commission has granted maximum deregulatory relief, United States Government Accountability Office (“GAO”) found that “list prices for dedicated access that apply under phase II, on average, *have increased*.”<sup>23</sup> Moreover, to the extent the

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<sup>20</sup> AT&T Comments at 73.

<sup>21</sup> *USTA v. FCC*, 359 F.3d 554, 589 (2004)(“*USTA II*”);

<sup>22</sup> Verizon Comments at 49; Qwest Comments at 9.

<sup>23</sup> “FCC Needs to Improve its Ability to Monitor and Determine the Extent of Competition in Dedicated Access Service,” United States Government Accountability Office, GAO- 07-80, at 13 (November 2006)(“GAO Report”)(emphasis added).

GAO found price decreases, it did not attribute any price decline to pricing flexibility or market forces, but instead to the *Calls Order* (“price-cap list prices available in phase I and price cap areas were pushed downward over the same period-*largely by the CALLS order.*”<sup>24</sup>) AT&T is also subject to merger conditions that limit their ability to raise prices on special access service, which unfortunately are set to expire this year.<sup>25</sup>

In conclusion, the Commission should judge the reasonableness of special access prices by comparing the prices for these facilities/services to their underlying cost, using the TELRIC rate for the comparable facilities/network components that track special access for the cost measure.

Respectfully submitted,

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<sup>24</sup> *Id.* (emphasis added.)

<sup>25</sup> *In the Matter of AT&T Inc. BellSouth Corporation Application for Transfer of Control*, Memorandum Opinion and Order, WC Docket No. 06-74, FCC 06-189, Appendix F (2007); Order on Reconsideration, WC Docket No. 96-74, FCC 07-44, ¶¶ 1, 5 and Appendix (2007).