

Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of
Special Access Rates for Price Cap Local Exchange Carriers
AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services
WC Docket No. 05-25
RM-10593

ORDER AND NOTICE OF PROPOSED RULEMAKING

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TABLE OF CONTENTS

Table with 2 columns: Section Title and Paragraph Number. Includes sections like INTRODUCTION, BACKGROUND, DISCUSSION, and various sub-sections with their corresponding paragraph numbers.

| | | |
|-----|--|-----|
| IV. | PROCEDURAL MATTERS | 132 |
| A. | <i>Ex Parte</i> Requirements | 132 |
| B. | Initial Paperwork Reduction Act Analysis | 133 |
| C. | Initial Regulatory Flexibility Analysis..... | 134 |
| D. | Comment Filing Procedures | 147 |
| V. | ORDERING CLAUSES | 152 |

I. INTRODUCTION

1. In this Notice of Proposed Rulemaking (NPRM), we commence a broad examination of the regulatory framework to apply to price cap local exchange carriers' (LECs) interstate special access services after June 30, 2005. In conducting this examination, we seek comment on the special access regulatory regime that should follow the expiration of the CALLS plan,¹ including whether to maintain or modify the Commission's pricing flexibility rules for special access services.²

2. On May 31, 2000, the Commission adopted the five-year CALLS plan that set forth, *inter alia*, the interstate access charge regime for special access services for price cap carriers.³ The Commission found that the special access rates for each year of the plan were reasonable.⁴ The CALLS plan was intended to run until June 30, 2005, but will continue after this date until the Commission adopts a subsequent plan. In this NPRM we seek comment on what steps the Commission should take to ensure that rates for special access services remain just and reasonable after the expiration of the CALLS plan.

3. Although we typically do not examine a single interstate access charges basket (*e.g.*, special access) separate from the other baskets (*e.g.*, common line, switched access, transport), we find that the increased importance of special access services relative to other access services warrants the initiation of a rulemaking proceeding specific to interstate special access charges. Notably, business customers, commercial mobile radio service (CMRS) providers, interexchange carriers (IXCs), and competitive LECs all use special access services as a key input in many of their respective service offerings.

¹ See *Access Charge Reform*, CC Docket Nos. 96-262, 94-1, 99-249, 96-45, 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 (2000) (*CALLS Order*), *aff'd in part, rev'd in part, and remanded in part*, *Texas Office of Public Util. Counsel v. FCC*, 265 F.3d 313 (5th Cir. 2001), *cert. denied*, *Nat'l Ass'n of State Util. Consumer Advocates v. FCC*, 535 U.S. 986 (2002), *on remand*, *Access Charge Reform*, CC Docket Nos. 96-262, 94-1, 99-249, 96-45, Order on Remand, 18 FCC Rcd 14976 (2003). See also *Cost Review Proceeding for Residential and Single-Line Business Subscriber Line Charge (SLC) Caps*, CC Docket Nos. 96-262, 94-1, Order, 17 FCC Rcd 10868 (2002), *aff'd*, *Nat'l Ass'n of State Util. Consumer Advocates v. FCC*, 372 F.3d 454 (D.C. Cir. June 29, 2004).

² See 47 C.F.R. §§ 69.701 *et seq.*; *Access Charge Reform*, CC Docket Nos. 96-262, 94-1, 98-63, 98-157, Fifth Report and Order and Further Notice of Proposed Rulemaking, 14 FCC Rcd 14221, 14224-25, 14232-33, 14234-35, 14257-310, paras. 1-4, 19, 24-26, 67-175 (1999) (*Pricing Flexibility Order*), *aff'd* *WorldCom v. FCC*, 238 F.3d 449 (D.C. Cir. 2001).

³ See *CALLS Order*, 15 FCC Rcd at 13014-39, paras. 129-184. CALLS stands for the Coalition for Affordable Local and Long Distance Service and consisted of AT&T, Bell Atlantic, BellSouth, GTE, SBC, and Sprint. *Id.* at 12964, para. 1.

⁴ See *id.*, 15 FCC Rcd at 12978-79, para. 41; see also 47 U.S.C. § 201(b) ("All charges . . . for and in connection with [interstate or foreign] communication service, shall be just and reasonable, and any such charge . . . that is unjust or unreasonable is hereby declared to be unlawful . . .").

Moreover, from 1991 (the first year of federal price cap regulation) to 2003, annual revenues from Bell Operating Company (BOC) interstate special access services increased from \$2.5 billion to \$13.5, and BOC special access revenues as a percentage of all BOC interstate operating revenues increased from 12.8 percent to 45.4 percent.⁵ The Commission commenced a comprehensive rulemaking proceeding in 2001 to reform intercarrier compensation, including an examination of the appropriate rate levels and rate structures for, *inter alia*, interstate switched access services.⁶ In 2004, numerous industry groups and other interested parties submitted intercarrier compensation reform proposals in that proceeding,⁷ and we will issue a further notice seeking comment on those proposals in the near future.

4. To ensure that our examination of the special access charge rules is sufficiently broad to establish the appropriate regulatory regime post-CALLS, we seek comment not only on traditional price cap issues, but also on the Commission's special access pricing flexibility rules. In 1999, the Commission established certain criteria under which price cap carriers may obtain the authority to provide special access services using more flexible contract tariffs, rather than standard, one-size fits all price cap tariffs.⁸ The Commission found that, using collocation by competitive carriers as predictive evidence of irreversible market entry, price cap LECs that meet certain evidentiary triggers may obtain pricing flexibility relief from our price cap rules.⁹

5. As part of our review of the pricing flexibility rules, which were adopted, in part, based on the Commission's predictive judgment, we will examine whether the available marketplace data support maintaining, modifying, or repealing these rules. We note that we are committed to re-examine periodically rules that were adopted on the basis of predictive judgments to evaluate whether those judgments are, in fact, corroborated by marketplace developments.¹⁰ Because we are undertaking an examination of the appropriate post-CALLS special access regime, we deem it appropriate at this time also to seek comment on whether actual marketplace developments support the predictive judgments that underlie the special access pricing flexibility rules.¹¹ We note that parties have already provided

⁵ See ARMIS 43-01, Table 1, Cost and Revenue, Rows 1090, 1290, columns h, s.

⁶ See *Developing a Unified Intercarrier Compensation Regime*, CC Docket No. 01-92, Notice of Proposed Rulemaking, 16 FCC Rcd 9610 (2001) (*Intercarrier Compensation NPRM*).

⁷ See, e.g., Regulatory Reform Proposal of the Intercarrier Compensation Forum, October 5, 2004 (ICF Proposal), attached to Letter from Gary M. Epstein and Richard R. Cameron, Counsel for the Intercarrier Compensation Forum, to Marlene H. Dortch, Sec'y, Federal Communications Commission, CC Docket No. 01-92, Tab A (filed Oct. 5, 2004).

⁸ See 47 C.F.R. §§ 69.701 *et seq.*; *Pricing Flexibility Order*, 14 FCC Rcd at 14257-312, paras. 67-178; see also *infra* section II.B.

⁹ *Pricing Flexibility Order*, 14 FCC Rcd at 14261-81, 14288-302, paras. 77-107, 121-56; see also *infra* section II.B.

¹⁰ See, e.g., *Aeronautical Radio, Inc. v. FCC*, 928 F.2d 428, 445 (D.C. Cir. 1991) (deferring to the Commission's predictive judgment "with the *caveat*, however, that, should the Commission's predictions . . . prove erroneous, the Commission will need to reconsider its [decision] in accordance with its continuing obligation to practice reasoned decisionmaking" [sic]) (emphasis in original); *Cellnet Communications, Inc. v. FCC*, 149 F.3d 429, 442 (6th Cir. 1998) (deferring to the Commission's predictions about the level of competition, but stating that, if the predictions do not materialize, the Commission "will of course need to reconsider its [decision] in accordance with its continuing obligation to practice reasoned decision-making").

¹¹ Although we choose to examine marketplace developments, we reject AT&T's contention that we are required to do so at this time. *AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, RM-10593, Petition for Rulemaking at 6-7, 35-36 (filed Oct. 15, 2002) (*AT&T Petition for Rulemaking*). Congress has not "provided a timetable or other indication of the speed with which it expects the agency to proceed" on rulemaking requests. See *Telecommunications Research Action Center v. FCC*, 750 F.2d 70, 80 (D.C. Cir. 1984).

conflicting data and analysis on this issue in response to the *AT&T Petition for Rulemaking*.¹² We seek additional data, as detailed below,¹³ and we incorporate the record already compiled in response to that petition into this proceeding.

6. Because we incorporate that record and address the AT&T petition here, we also respond to AT&T's request for interim relief. AT&T claims that, despite the BOCs satisfying the pricing flexibility triggers in many markets and the Commission's prediction that this would serve as indicia of competitive market entry, competitive entry has not occurred.¹⁴ It contends, moreover, that the BOCs have used pricing flexibility to maintain or raise rates, not to lower rates in response to predicted competitive entry.¹⁵ It thus asserts that the BOCs' special access rates are at supracompetitive levels.¹⁶ To remedy these alleged problems, AT&T requests that we initiate a rulemaking.¹⁷ It also asks that we reinitialize Phase II pricing flexibility special access rates at an 11.25 percent rate of return, and impose a temporary moratorium on further pricing flexibility applications.¹⁸ As we explain *infra* in section III.C, we deny AT&T's request to re-initialize special access rates and to impose a moratorium on consideration of further pricing flexibility applications. We also seek comment on whether we should adopt any interim requirements in the event that the Commission is unable to conclude this NPRM in time for any adopted rule changes to be implemented in the 2005 annual tariff filings.

II. BACKGROUND

7. To recover the costs of providing interstate access services, price cap LECs charge IXCs, competitive LECs, CMRS providers, and end users for access services in accordance with our Part 61 and Part 69 access charge rules.¹⁹ There are two basic categories of access services: special access services and switched access services. Special access services do not use local switches; instead they employ dedicated facilities that run directly between the end user and the IXC's point of presence (POP) or between two discrete end user locations.²⁰ Switched access services, on the other hand, use local exchange switches to route originating and terminating interstate toll calls.²¹

8. Charges for special access services generally are divided into channel termination charges and channel mileage charges. Channel termination charges recover the costs of facilities between the customer's premises and the LEC end office and the costs of facilities between the IXC POP and the LEC serving wire center.²² Channel mileage charges recover the costs of facilities (also known as interoffice facilities) between the serving wire center and the LEC end office serving the end user. The special

¹² See *infra* section II.C.

¹³ See *infra* section III.B.

¹⁴ *AT&T Petition for Rulemaking* at 2, 6-7, 11-13, 20, 25-32.

¹⁵ *Id.* at 11-13.

¹⁶ *Id.* at 1-6, 20, 34-35.

¹⁷ *Id.* at 1, 5-7.

¹⁸ *Id.* at 6, 39-40.

¹⁹ 47 C.F.R. Parts 61 (access charge rate levels), 69 (access charge rate structures).

²⁰ A POP is the physical point where an IXC connects its network with the LEC network.

²¹ See *Pricing Flexibility Order*, 14 FCC Rcd at 14226, para. 8.

²² "Serving wire center means the telephone company central office designated by the telephone company to serve the geographic area in which the interexchange carrier or other person's point of demarcation is located." 47 C.F.R. § 69.2(rr).

access rates for price cap incumbent LECs are currently subject to two pricing regimes – price caps and pricing flexibility.²³

A. Price Cap Regulation

1. History

9. Through the end of 1990, interstate access charges were governed by "rate-of-return" regulation, under which incumbent LECs calculated their access rates using projected costs and projected demand for access services.²⁴ An incumbent LEC was limited to recovering its costs plus a prescribed return on investment. It also was potentially obligated to provide refunds if its interstate rate of return exceeded the authorized level. Thus, a rate of return regulatory structure bases a firm's allowable rates directly on the firm's reported costs and was thus subject to criticisms that it removed the incentive to reduce costs and improve productive efficiency.²⁵

10. Consequently, in 1991 the Commission implemented a system of price cap regulation that altered the manner in which the largest incumbent LECs (often referred to today as price cap LECs) established their interstate access charges.²⁶ The Commission's price cap plan for LECs was intended to avoid the perverse incentives of rate-of-return regulation in part by divorcing the annual rate adjustments from the performance of each individual LEC, and in part by adjusting the cap based on actual industry productivity experience.²⁷

11. In contrast to rate-of-return regulation, which limits the *profits* an incumbent LEC may earn, price cap regulation focuses primarily on the *prices* that an incumbent LEC may charge and the *revenues* it may generate from interstate access services. The access charges of price cap LECs originally were set at levels based on the rates that existed at the time they entered price caps. Their rates have, however, been limited over the course of price cap regulation by price indices that are adjusted annually pursuant to formulae set forth in our Part 61 rules. The price cap formula traditionally included a productivity factor (the "X-factor") that represented the extent to which the overall LEC productivity growth rate could be expected to exceed the productivity growth rate of the economy as a whole. Price cap carriers whose interstate access charges are set by these pricing rules are permitted to earn returns significantly higher, or potentially lower, than the prescribed rate of return that incumbent LECs are allowed to earn under rate-of-return rules. Price cap regulation encourages incumbent LECs to improve their efficiency by harnessing profit-making incentives to reduce costs, invest efficiently in new plant and facilities, and develop and deploy innovative service offerings, while setting price ceilings at reasonable levels.²⁸ In the

²³ See *Pricing Flexibility Order*, 14 FCC Rcd at 14227, para. 10.

²⁴ Since 1981, the Commission has allowed certain smaller incumbent LECs to base their access rates on historic, rather than projected, cost and demand. See 47 C.F.R. § 61.39.

²⁵ See *CALLS Order*, 15 FCC Rcd at 12968, paras. 13, 15.

²⁶ The Commission required price cap regulation for the BOCs and GTE, and permitted other LECs to elect price cap regulation voluntarily, provided that all their affiliates also convert to price cap regulation and that they withdraw from the pools administered by the National Exchange Carrier Association (NECA). *Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786, 6818-20, paras. 257-59 (1990) (*LEC Price Cap Order*), *aff'd Nat'l Rural Telecom Ass'n v. FCC*, 988 F.2d 174 (D.C. Cir. 1993). Most rural and small LECs elected to remain subject to rate-of-return regulation.

²⁷ See *CALLS Order*, 15 FCC Rcd at 12968, para. 14.

²⁸ The price cap regulations also give incumbent LECs greater flexibility in determining the amount of revenues that may be recovered from a given access service. The price cap rules group services together into different baskets, service categories, and service subcategories. The rules then identify the total permitted revenues for each basket or category of services. Within these baskets or categories, incumbent LECs are given some discretion to determine

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short run, the behavior of individual companies has no effect on the prices they are permitted to charge, and they are able to keep any additional profits resulting from reduced costs. This creates an incentive to cut costs and to produce efficiently. In this way, price caps act as a transitional regulatory scheme until the advent of actual competition makes price cap regulation unnecessary.²⁹

12. Although price cap regulation diminished the direct link between changes in allocated accounting costs and change in prices, it did not sever the connection between accounting costs and prices entirely. Rather, because the rates to which the price cap formulae were originally applied resulted from rate-of-return regulation, overall price cap LEC interstate revenue levels continued generally to reflect the accounting and cost allocation rules used to develop access charges.³⁰ Moreover, earnings remain relevant to price cap regulation on several respects. First, price cap indices may be adjusted upward if a price cap carrier earns returns below a specified level in a given year (referred to as a “low-end” adjustment).³¹ Second, a price cap LEC may petition the Commission to set its rates above the levels permitted by the price cap indices based on a showing that the authorized rate levels will produce earnings that are so low as to be confiscatory (referred to as an “above-cap filing”).³² Third, in the past, all or some price cap LECs were required to “share,” or return to ratepayers, earnings above specified levels. This sharing requirement was eliminated in 1997.³³

13. With the passage of the Telecommunications Act of 1996 (1996 Act),³⁴ the Commission determined that it was necessary to undertake substantial access charge reform.³⁵ In 1997 in the *Access Charge Reform Order*, for example, the Commission instituted reforms that changed the manner in which price cap LECs recover access costs by aligning the rate structure more closely with the manner in which costs are incurred.³⁶ The Commission stated, moreover, that it would rely on competition as the primary method for bringing about cost-based access charges.³⁷ It anticipated creating, in a later stage of access

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the portion of revenue that may be recovered from specific services. Subject to certain restrictions, this flexibility allows incumbent LECs to alter the rate level associated with a given service. *CALLS Order*, 15 FCC Rcd at 12968-69, para. 16 n.15.

²⁹ See *id.*, 15 FCC Rcd at 12968-69, para. 16 (citing *Price Cap Performance Review for Local Exchange Carriers*, Second Further Notice of Proposed Rulemaking in CC Docket No. 94-1, Further Notice of Proposed Rulemaking in CC Docket No. 93-124, and Second Further Notice of Proposed Rulemaking in CC Docket No. 93-197, 11 FCC Rcd 858, 862, paras. 5-6 (1995) (*Price Cap Second FNPRM*)).

³⁰ See *id.*, 15 FCC Rcd at 12968, para. 17.

³¹ See *id.* In 1999, the low-end adjustment was eliminated for those LECs that receive and exercise pricing flexibility. See *infra* section II.B.

³² See *CALLS Order*, 15 FCC Rcd at 12968, para. 17.

³³ See *id.* (citing *Price Cap Performance Review for Local Exchange Carriers*, Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262, 12 FCC Rcd 16642, 16991, 16700-03, paras. 127, 148-55 (1997) (*1997 Price Cap Review Order*), *aff'd in part, rev'd in part*, *United States Telecom Ass'n v. FCC*, 188 F.3d 521 (D.C. Cir. 1999)).

³⁴ Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996). The 1996 Act amended the Communications Act of 1934, 47 U.S.C. § 151 *et seq.* We refer to these Acts collectively as the “Communications Act.”

³⁵ See *CALLS Order*, 15 FCC Rcd at 12969-70, para. 18.

³⁶ *Access Charge Reform*, CC Docket Nos. 96-262, 94-1, 91-213, 95-72, First Report and Order, 12 FCC Rcd 15982, 16007-34, paras. 67-122 (1997) (*Access Charge Reform Order*), *aff'd Southwestern Bell Tel. Co. v. FCC*, 153 F.3d 523 (8th Cir. 1998).

³⁷ *Access Charge Reform Order*, 12 FCC Rcd at 16001-02, para.44.

reform, a mechanism whereby it would lessen, and eventually eliminate, rate regulation as competition developed.³⁸ 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.³⁹ To assist in that effort, the Commission said it would require price cap LECs to start forward-looking cost studies no later than February 8, 2001 for all services then remaining under price caps.⁴⁰

2. The CALLS Plan

14. Subsequently, in 2000, after a comprehensive examination of the interstate access charge and universal service regulatory regimes for price cap carriers, the Commission adopted the industry-proposed CALLS plan.⁴¹ This plan represents a five-year interim regime designed to phase out implicit subsidies and (as it pertains to access charges) to move towards a more market-based approach to ratesetting.⁴² In adopting the CALLS plan, the Commission offered price cap carriers the choice of completing the forward-looking cost studies required by the *Access Charge Reform Order* or voluntarily making the rate reductions required under the five-year CALLS plan.⁴³ The Commission permitted carriers to defer the planned forward-looking cost studies in favor of the CALLS plan because it found the plan to be “a transitional plan that move[d] the marketplace closer to economically rational competition, and it [would] enable [the Commission], once such competition develops, to adjust our rules in light of relevant marketplace developments.”⁴⁴ All price cap carriers opted for the CALLS plan.⁴⁵

15. The CALLS plan separated special access services into their own basket and applied a separate X-factor to the special access basket.⁴⁶ The X-factor under the CALLS plan, unlike under prior price cap regimes, is not a productivity factor. Rather, it represents “a transitional mechanism . . . to lower rates for a specified period of time for special access.”⁴⁷ The special access X-factor was 3.0 percent in 2000 and 6.5 percent in 2001, 2002, and 2003. In addition to the X-factor, access charges under CALLS are adjusted for inflation as measured by the Gross Domestic Product-Price Index (GDP-PI).⁴⁸ For the final year of the CALLS plan (July 1, 2004 – June 30, 2005), the special access X-factor is set equal to inflation, thereby freezing rate levels.⁴⁹ Thus, absent the implementation of a new price cap regime post-CALLS, price cap LECs’ special access rates will remain frozen at 2003 levels (unless any

³⁸ *Id.*, 12 FCC Rcd at 16003, paras. 48-49.

³⁹ *Id.*, 12 FCC Rcd at 16002-03, para. 47.

⁴⁰ *Id.*, 12 FCC Rcd at 16003, para. 48; *see CALLS Order*, 15 FCC Rcd at 12970, para. 20.

⁴¹ *CALLS Order*, 15 FCC Rcd 12962.

⁴² *See id.*, 15 FCC Rcd at 12965, 12977-79, paras. 4, 36-42.

⁴³ *Id.*, 15 FCC Rcd at 12974, 12983-86, paras. 29, 56-62.

⁴⁴ *Id.*, 15 FCC Rcd at 12977, para. 36.

⁴⁵ *See Petition for Forbearance of Iowa Telecommunications Services, Inc. d/b/a Iowa Telecom Pursuant to 47 U.S.C. § 160(c) from the Deadline for Price Cap Carriers to Elect Access Rates Based on the CALLS Order or a Forward Looking Cost Study*, CC Docket No. 01-131, Order, 17 FCC Rcd 24319, 24320, at para. 3 (2002).

⁴⁶ *CALLS Order*, 15 FCC Rcd at 12974-75, 13033-34, paras. 30, 172. The CALLS plan also retained the low-end adjustment for price cap LECs. *Id.* at 13038, para. 182.

⁴⁷ *Id.*, 15 FCC Rcd at 13028, para. 160.

⁴⁸ *Id.*, 15 FCC Rcd at 13038, para. 183.

⁴⁹ *Id.*, 15 FCC Rcd at 13025, para. 149. Because rates are both reduced by and increased by the inflation rate, they are effectively frozen. *See infra* para. 30.

exogenous cost adjustments are necessary).⁵⁰ The Commission hoped that, by the end of the five-year CALLS plan, competition would exist to such a degree that deregulation of access charges for price cap LECs would be the next logical step.⁵¹

B. Pricing Flexibility

16. Pursuant to the pro-competitive, deregulatory mandates of the 1996 Act, in 1996 the Commission began exploring whether and how to remove price cap LECs' access services from price cap and tariff regulation once they are subject to substantial competition.⁵² Three years later, in 1999, the Commission adopted the *Pricing Flexibility Order* to ensure that the Commission's interstate access charge regulations did not unduly interfere with the operation of interstate access markets as competition developed in those markets.⁵³ The Commission developed competitive triggers designed to measure the extent to which competitors had made irreversible, sunk investment in collocation and transport facilities.⁵⁴ Price cap carriers that satisfy those triggers may obtain the pricing flexibility to offer special access services at unregulated rates through generally available and individually negotiated tariffs (*i.e.*, contract tariffs).⁵⁵

17. Pricing flexibility permits the LEC to enter into more individualized relationships with its special access customers. Pricing flexibility may be obtained by price cap LECs in two separate phases, each on a Metropolitan Statistical Area (MSA) basis. Under Phase I relief, a price cap carrier may offer volume and term discounts and contract tariffs for interstate special access services unconstrained by the Commission's Part 61 rate level rules and Part 69 rate structure rules.⁵⁶ To protect those customers that may lack competitive alternatives, however, the price cap LEC must continue to offer its generally available, price cap constrained (*i.e.*, subject to both Part 61 and Part 69) tariff rates for these services.⁵⁷ Under Phase II relief, a price cap carrier may file individualized special access contract tariffs, subject only to continuing to make available generalized special access tariff offerings.⁵⁸ Neither the contract

⁵⁰ 47 C.F.R. § 61.45(b)(1)(iv) ("Starting in the 2004 annual filing, X shall be equal to GDP-PI for the special access basket.").

⁵¹ *CALLS Order*, 15 FCC Rcd at 12977, para. 35.

⁵² See *Access Charge Reform*, CC Docket Nos. 96-262, 94-1, 91-213, 96-263, Notice of Proposed Rulemaking, Third Report and Order, and Notice of Inquiry, 11 FCC Rcd 21354, 21357-58, 21363, paras. 1, 15 (1996) (*Access Charge NPRM, Order, and NOI*).

⁵³ *Pricing Flexibility Order*, 14 FCC Rcd at 14224, para. 1.

⁵⁴ *Id.*, 14 FCC Rcd at 14261, paras. 77-83.

⁵⁵ *Id.*, 14 FCC Rcd 14287-94, 14301-02, paras. 122-33, 153-55. Although the Commission developed pricing flexibility triggers for both special access and switched access services, we address only special access services in this NPRM.

⁵⁶ To obtain Phase I relief for interstate special access services other than channel terminations between a LEC end office and an end user's customer premises, a price cap LEC must demonstrate that unaffiliated competitors have collocated in at least 15 percent of the LEC's wire centers within an MSA or collocated in wire centers accounting for 30 percent of the LEC's revenues from these services within the MSA. To obtain Phase I pricing flexibility for channel terminations between a LEC end office and a customer premises, the LEC must demonstrate that unaffiliated competitors have collocated in at least 50 percent of the LEC's wire centers within an MSA or collocated in wire centers accounting for 65 percent of the LEC's revenues from these services within the MSA. 47 C.F.R. §§ 69.709, 69.711; *Pricing Flexibility Order*, 14 FCC Rcd at 14235-36, 14273-77, paras. 24, 93-99.

⁵⁷ *Pricing Flexibility Order*, 14 FCC Rcd at 14235-36, para. 24.

⁵⁸ To obtain Phase II relief for special access services other than channel terminations to end users, the trigger thresholds are unaffiliated collocation in 50 percent of the LEC's wire centers or in wire centers accounting for 65 percent of the LEC's revenues from these services within the MSA. For channel terminations to end users, the

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tariffs nor the general offerings are constrained by our Part 61 or our Part 69 rules.⁵⁹ A LEC that obtains and exercises pricing flexibility (Phase I or II) for any MSA is precluded, at the holding company level, from applying for a low-end adjustment.⁶⁰

18. The Commission adopted pricing flexibility to provide regulatory relief for special access services coincident with the development of competition for these services.⁶¹ It determined that, “because regulation is not an exact science,” it could not time the grant of pricing flexibility relief to coincide precisely with the introduction of interstate special access alternatives for every end user.⁶² The Commission further determined that, in light of the showing necessary to satisfy the triggers, the costs of delaying regulatory relief outweighed the risks of granting relief too soon.⁶³ In particular, the Commission found that the triggers would accurately predict the existence of competitive pressures that would discipline interstate special access rates.⁶⁴ It thus explained that “[t]he pricing flexibility framework . . . is designed to grant greater flexibility to price cap LECs as competition develops, while ensuring that: (1) price cap LECs do not use pricing flexibility to deter efficient entry or engage in exclusionary pricing behavior; and (2) price cap LECs do not increase rates to unreasonable levels for customers that lack competitive alternatives.”⁶⁵ On February 2, 2001, the D.C. Circuit upheld the *Pricing Flexibility Order*, finding that the Commission made a reasonable policy determination and sufficiently explained its basis for doing so.⁶⁶

C. AT&T’s Petition for Rulemaking

19. On October 15, 2002, AT&T Corp. filed a petition for rulemaking essentially requesting that the Commission revoke the pricing flexibility rules and revisit the CALLS plan as it pertains to the rates that price cap LECs, and the BOCs in particular, charge for special access services.⁶⁷ AT&T claims that the pricing flexibility triggers fail to predict price-constraining competitive entry and, rather, that significant competitive entry has not occurred.⁶⁸ It further contends that, based on Automated Reporting Management Information System (ARMIS) data, the BOCs’ interstate special access revenues more than tripled, from \$3.4 billion to \$12.0 billion, between 1996 and 2001 and that their returns on special access services were between 21 and 49 percent in 2001.⁶⁹ Further, AT&T states that, in every MSA for which

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Phase II thresholds are unaffiliated collocation in 65 percent of the LEC’s wire centers or in wire centers accounting for 85 percent of the LEC’s revenues for these services. 47 C.F.R. §§ 69.709, 69.711; *Pricing Flexibility Order*, 14 FCC Rcd at 14235, 14298-300, paras. 25, 146-52.

⁵⁹ *Pricing Flexibility Order*, 14 FCC Rcd at 14235, 14301-02, paras. 25, 153-55.

⁶⁰ *Id.*, 14 FCC Rcd at 14304-07, paras. 162-68.

⁶¹ *Id.*, 14 FCC Rcd 14224-25, 14271-72, 14297-98, paras. 2, 90, 144.

⁶² *Id.*, 14 FCC Rcd at 14297-98, para. 144.

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.*, 14 FCC Rcd at 14225, para. 3.

⁶⁶ *WorldCom v. FCC*, 238 F.3d 449, 452 (D.C. Cir. 2001).

⁶⁷ *AT&T Petition for Rulemaking* at 1, 6, 39-40. Competitive LECs and telecommunications users generally support the *AT&T Petition for Rulemaking*. See, e.g., Ad Hoc Telecommunications Users Committee Comments at 1-7; American Petroleum Institute Comments at 1-5; AT&T Wireless Comments at 1-7; PacTec Comments at 1-6; WorldCom Comments at 1-14.

⁶⁸ *AT&T Petition for Rulemaking* at 2, 6-7, 11-13, 20, 25-32.

⁶⁹ *Id.* at 3-4, 8-9, 14.

pricing flexibility was granted, BOC special access rates either remained flat or increased.⁷⁰ Thus, AT&T contends both that the predictive judgment at the core of the *Pricing Flexibility Order* has not been confirmed by marketplace developments, and that BOC special access rates are at supracompetitive levels that are unjust and unreasonable in violation of section 201 of the Communications Act.⁷¹ Because the predictive judgment has proven wrong, AT&T asserts, the Commission is compelled to revisit its pricing flexibility rules in a rulemaking proceeding.⁷² During the pendency of this rulemaking, AT&T requests that we grant interim relief (1) reducing the rates for all special access charges subject to Phase II pricing flexibility to the rates that an 11.25 percent rate of return would generate, and (2) imposing a pricing flexibility moratorium.⁷³

20. Price cap LECs generally oppose the *AT&T Petition for Rulemaking*. They claim that their special access rates are reasonable and therefore lawful, that there is robust competition in the special access market, that the collocation-based triggers are an accurate metric for competition, and that the data relied upon by AT&T are unreliable in the context used by AT&T.⁷⁴ SBC notes that AT&T only provided (and could only provide) data from a single year (2001) that post-dates the initial implementation of Phase II pricing flexibility in 2001,⁷⁵ and SBC and Verizon claim that ARMIS data are not designed to evaluate the reasonableness of rates.⁷⁶ The BOCs contend, moreover, that special access revenues per line declined between 1996 and 2001.⁷⁷

21. On November 6, 2003, AT&T filed a petition for mandamus with the D.C. Circuit, requesting the court to direct the Commission to act on its rulemaking petition and to grant the interim relief sought.⁷⁸ On March 23, 2004, the court on its own motion referred the mandamus petition to a merits panel.⁷⁹ On July 1, 2004, the Commission submitted its brief to the court.⁸⁰ The court heard oral argument on the mandamus petition on October 21, 2004. Subsequently, the court held the matter in abeyance, requiring that the Commission provide it with a status report on December 1, 2004, and on

⁷⁰ *Id.* at 11-13.

⁷¹ *Id.* at 1-6, 20, 34-35.

⁷² *Id.* at 6-7, 35-36.

⁷³ *Id.* at 6, 39-40. AT&T also requests that we exempt special access purchasers that take advantage of this relief (if granted) from any early termination liabilities. *Id.* at 6, 40.

⁷⁴ *See, e.g.*, SBC Opposition at 10-13, 19, 22-24; Verizon Opposition at 9-10, 13-14, 17, 21.

⁷⁵ SBC Opposition at 16.

⁷⁶ *Id.* at 22; Verizon Opposition at 21.

⁷⁷ *E.g.*, SBC Opposition at 23-24, Declaration of Alfred E. Kahn and William E. Taylor at 15. We note that the Declaration of Alfred E. Kahn and William E. Taylor was attached separately to the BellSouth Opposition, the Qwest Opposition, the SBC Opposition, and the Verizon Opposition. We therefore refer to it as the “Kahn/Taylor Decl.,” without reference to a particular party, throughout the remainder of this NPRM.

⁷⁸ *AT&T Corp., et al.*, D.C. Circuit Case No. 03-1397, Petition for a Writ of Mandamus (filed Nov. 6, 2003). The following parties jointly submitted the mandamus petition with AT&T: AT&T Wireless, The CompTel/ASCENT Alliance, eCommerce and Telecommunications Users Group, and The Information Technology Association of America.

⁷⁹ *AT&T Corp., et al.*, D.C. Circuit Case No. 03-1397, Order (March 23, 2004).

⁸⁰ *AT&T Corp., et al.*, D.C. Circuit Case No. 03-1397, Brief for Federal Communications Commission (filed July 1, 2004).

February 1, 2005.⁸¹ The Commission provided the court with the required status report on December 1, 2004.⁸²

III. DISCUSSION

22. Given the importance of special access services to carriers and customers alike, we commence this proceeding to seek comment on the interstate special access regime that we should put in place post-CALLS. To ensure that our examination is complete, we also seek comment on whether, as part of that regime, we should maintain, modify, or repeal the Commission's pricing flexibility rules. Finally, because this proceeding likely will not be completed in time for a new special access regime to be implemented in the 2005 annual access tariff filings, we seek comment on whether interim relief may be warranted and, if so, under what circumstances.

23. As a threshold matter, we request that any party that comments on the appropriate post-CALLS special access regulatory regime and/or that proposes the Commission alter in any way the existing pricing flexibility rules include in its comments specific language that would codify its proposed special access regulatory regime and/or its proposed pricing flexibility rule change(s).⁸³

A. Interstate Special Access Rates of Price Cap LECs Post-CALLS

24. The first step in establishing the post-CALLS special access rate regulatory regime is to determine the type of rate regulation, if any, that should apply. We tentatively conclude that we should continue to regulate special access rates under a price cap regime and that the price cap regime should continue to include pricing flexibility rules that apply where competitive market forces constrain special access rates. This approach will allow the market to determine rates where competitive market forces exist, while protecting special access consumers from unreasonable rates where competition is lacking. Such a regime, we tentatively conclude, would result in just and reasonable rates as required under section 201 of the Communications Act.⁸⁴ We seek comment on these tentative conclusions.

25. Consistent with these tentative conclusions, in this section we discuss the major issues with respect to implementing a price cap method to regulate special access rates and seek comment on how to resolve these issues. In section III.B, *infra*, we discuss and seek comment on the appropriate pricing flexibility aspects of a price cap regime.

1. Changes in the Special Access Market

26. Special access services have significant economies of scale and scope. Most of the cost of providing a special access line is in the support structure, *i.e.*, the trenches, manholes, poles, and conduits, the rights-of-way, and the access to buildings, not in the fiber strand or copper wires that share the support

⁸¹ *AT&T Corp., et al.*, D.C. Circuit Case No. 03-1397, Order (Oct. 25, 2004) (holding the matter in abeyance and requiring the Commission submit a status report on Dec. 1, 2004); *AT&T Corp., et al.*, D.C. Circuit Case No. 03-1397, Order (Dec. 8, 2004) (continuing to hold the matter in abeyance and requiring the Commission to submit a second status report on Feb. 1, 2005).

⁸² *AT&T Corp., et al.*, D.C. Circuit Case No. 03-1397, Status Report of Federal Communications Commission (filed Dec. 1, 2004).

⁸³ For example, in support of the CALLS proposal, the CALLS members submitted specific proposed rule changes. *See, e.g., Access Charge Reform*, CC Docket Nos. 96-262, 94-1, 99-245, 96-45, Memorandum in Support of the Coalition for Affordable Local and Long Distance Service Plan at App. B (filed Aug. 20, 1999). Parties should likewise submit their proposed specific rule changes as part of their comments in this proceeding.

⁸⁴ *See* 47 U.S.C. § 201(b).

structure, rights, and access.⁸⁵ Structure, rights, and access costs vary little with respect to the number of fiber strands or copper wires, thereby producing economies of scale. Price cap LECs can, moreover, increase capacity on many special access routes at a relatively low incremental cost (relative to the total cost of trenching and placing poles, manholes, conduit, fiber, and copper, and securing rights and access) by adding or upgrading terminating electronics.⁸⁶

27. The first full year of the CALLS plan and the first year that price cap LECs exercised significant pricing flexibility was 2001.⁸⁷ ARMIS data show that, in the 2001-2003 period, BOC special access operating revenues, operating expenses, accounting rates of return, and the number of special access lines increased annually (*i.e.*, compound annual growth rates over the period) by approximately 12, 7, 17, and 18 percent, respectively.⁸⁸ BOC special access average investment decreased at a compounded annual rate of less than one percent over the same period.⁸⁹ The overall (*i.e.*, not compounded annually) BOC interstate special access accounting rates of return were approximately 38, 40, and 44 percent in 2001, 2002, and 2003, respectively.⁹⁰

28. In the period 1992-2000, a period that precedes the CALLS plan and significant pricing flexibility, BOC interstate special access operating revenues, operating expenses, average investment, accounting rates of return, and special access lines increased at a compounded annual rate of

⁸⁵ See *AT&T Petition for Rulemaking* at 29; Kahn/Taylor Decl. at 10-11.

⁸⁶ See *AT&T Petition for Rulemaking* at 29.

⁸⁷ See *supra* sections II.A.2 (CALLS), II.B (pricing flexibility).

⁸⁸ The compound annual growth rates for operating revenues, operating expenses, and rate of return were calculated using ARMIS data reported for interstate special access services (entered as of September 29, 2004). The underlying operating revenues and operating expenses data are from ARMIS 43-01, Table I, Cost and Revenue, rows 1090, 1190, cols. s. Net return is divided by average net investment to calculate annual rates of return for which the compound annual growth rate is calculated. The underlying net return and average net investment data are from ARMIS 43-01, Table 1, Cost and Revenue, rows 1910, 1915, col. s. We calculated the compound annual growth rate for special access analog and digital lines collectively using ARMIS data reported for interstate and state special access services. These special access lines are expressed in voice grade equivalents in the ARMIS reports. The underlying special access analog and digital line data are in ARMIS, 43-08, Table III, Access Lines in Service by Customer, row 910, cols. fj and fk. The ARMIS report does not identify separately the number of interstate and the number of state special access lines. The compound annual growth rate for state and interstate special access lines should be similar to the growth rate for interstate special access lines alone, because state special access revenues alone represent a relatively small fraction of combined state and interstate special access service revenues. Specifically, BOC interstate special access operating revenues were approximately \$13.5 billion in 2003. See ARMIS 43-01, Table I, Cost and Revenue, row 1090, col. s. Of this amount, approximately \$12.9 billion, or 96 percent, is reported as network access service revenue for special access services. See ARMIS 43-01, Table I, Cost and Revenue, row 1020, col. s. Although ARMIS does not report a figure for the state jurisdiction that is directly comparable to special access operating revenues, it does report that, in 2003, approximately \$1.6 billion revenues for state network access service revenues-special access. See ARMIS 43-04, Table I, Separations and Access Data, row 4012, col. c. The state network access service revenue-special access is approximately 11 percent of the total for state and interstate network access service revenue-special access. The state share of the total of state and the interstate special access lines should be similar. Moreover, use of the compound annual growth rate for state and interstate special access lines collectively to estimate the growth rate for interstate special access lines alone is reasonable because there is no evidence that state special access lines are growing at a significantly different rates than are interstate special access lines.

⁸⁹ The compound annual growth rate for average net investment is calculated from ARMIS data reported for interstate special access services. See ARMIS 43-01, Table I, Cost and Revenue, row 1910, col. s.

⁹⁰ The annual rates of return were calculated using ARMIS data reported for interstate special access services. Specifically, we divided the net return by average net investment to calculate the rates of return. See ARMIS 43-01, Table 1, Cost and Revenue, rows 1910, 1915, col. s.

approximately 16, 12, 11, 11, and 32 percent, respectively.⁹¹ The overall (non-compounded) BOC special access accounting rates of return varied over this period from a low of approximately 7 percent in 1995 to a high of approximately 28 percent in 2000.⁹²

29. These accounting data suggest that the BOCs have realized special access scale economies throughout the entire period of price cap regulation, including before and after the CALLS plan and pricing flexibility were implemented. That is, special access line demand increased at a significantly higher rate than did operating expenses and investment throughout these periods, suggesting that the BOCs realized scale economies in both periods. We note that some parties contend that the accounting rates of return derived from ARMIS data are meaningless.⁹³ Here, we use ARMIS data for the limited purpose of examining the relationship between demand growth and growth in expenses and investment. To the extent the accounting rules have remained the same over the period analyzed, the analysis of growth rates and scale economies should not be significantly affected by the cost allocation issues these parties raise. We invite parties to comment on the relevance of these data and the relationship between demand growth and growth in expenses and investment in the special access market. To demonstrate the possible impact of cost allocations during the price cap period of regulation, including before and after the CALLS plan and pricing flexibility were implemented, we invite parties (1) to remove from the BOCs' interstate special access operating expenses and average investment data reported in ARMIS any expenses and investments that are not directly assignable; and (2) to calculate the compound annual growth rates for BOC interstate special access operating expenses and average investment using these adjusted data. To the extent parties have concerns about the consideration of ARMIS data for purposes of evaluating the degree to which special access rates and therefore earnings exceed a reasonable level, we solicit comment on that issue below.⁹⁴

2. Developing a Special Access Price Cap Regime

30. The core component of price cap regulation is the Price Cap Index (PCI). As the Commission explained in the *LEC Price Cap Order*, the PCI is designed to limit the prices LECs charge for service.⁹⁵ The PCI provides a benchmark of LEC cost changes that encourages price cap LECs to become more productive and innovative by permitting them to retain reasonably higher earnings.⁹⁶ The PCI has three basic components: (1) a measure of inflation, *i.e.*, the Gross Domestic Product (chain weighted) Price Index (GDP-PI);⁹⁷ (2) a productivity factor or "X-Factor," that represents the amount by

⁹¹ See *supra* notes 88-89. We begin our analysis with 1992, rather than 1991, data because ARMIS does not contain line count data for 1990; thus, the compound annual growth rate cannot be calculated from these data in 1991.

⁹² See *supra* note 90.

⁹³ See, *e.g.*, SBC Opposition at 19-23; Kahn/Taylor Decl. at 6-9 (claiming that accounting rates of return for services such as interstate special access services are meaningless because these returns reflect arbitrary allocations of fixed costs between regulated and non-regulated services, between interstate and intrastate jurisdictions, and among interstate services).

⁹⁴ See *infra* section III.A.4.

⁹⁵ *LEC Price Cap Order*, 5 FCC Rcd at 6792, para. 47. To ascertain compliance with the PCI, LEC rate levels within each basket are measured through the use of an Annual Price Index (API). The API is the weighted sum of the percentage change in LEC prices. The API weights the rate for each rate element in the basket based on the quantity of each element sold in a historical base year. The historical base year is the calendar year that immediately precedes the annual tariff filing on July 1. A price cap LEC's rates are in compliance with the cap for a basket if the API is less than or equal to the PCI.

⁹⁶ *Id.*, 5 FCC Rcd at 6787, 6792, paras. 2-3, 47.

⁹⁷ *CALLS Order*, 15 FCC Rcd at 13038-39, paras. 183-84.

which LECs can be expected to outperform economy-wide productivity gains;⁹⁸ and (3) adjustments to account for “exogenous” cost changes that are outside the LEC’s control and not otherwise reflected in the PCI.⁹⁹ While we seek comment on whether and, if so, how to develop a new special access price cap, we focus our inquiry below on productivity and growth issues and on developing service categories and subcategories. Parties may comment on whether we should include inflation and exogenous cost adjustments in a new special access price cap regime. We tentatively conclude, however, that, except as otherwise discussed herein, we should retain the same method of revising the PCI to reflect inflation and exogenous cost adjustments that presently apply to special access services.

a. Productivity Factor or X-Factor

31. The X-factor adopted in the *LEC Price Cap Order* consisted of a component based on historical LEC productivity, and an additional productivity obligation of 0.5 percent that represented a consumer productivity dividend (CPD) by which the first LEC productivity gains were assigned to customers in the form of lower rates.¹⁰⁰

32. Initially, price cap LECs were required to share a portion of their earnings in excess of specified rates of return with their access customers by temporarily reducing the price cap ceiling in a subsequent period.¹⁰¹ In 1990, the Commission prescribed two X-factors: (1) a minimum 3.3 percent X-factor, and (2) an optional 4.3 percent X-factor.¹⁰² Price cap LECs that selected the higher X-factor were allowed to retain larger shares of their earnings.¹⁰³ In the *1995 Price Cap Review Order*, the Commission increased the minimum X-factor to 4.0 percent and replaced the single optional X-factor with two optional X-factors, 4.7 and 5.3 percent.¹⁰⁴ Subsequently, in the *1997 Price Cap Review Order*, the Commission eliminated all requirements to share earnings and prescribed a 6.5 percent X-factor,¹⁰⁵ based primarily on a staff study of the historical LEC total factor productivity growth rate (TFP study).¹⁰⁶ The D.C. Circuit reversed and remanded the *1997 Price Cap Review Order* for further explanation of the Commission’s decision to adopt a 6.5 percent X-factor.¹⁰⁷

33. The Commission subsequently commenced a rulemaking proceeding seeking comment on alternative bases for prescribing an X-factor. In the *1999 Price Cap FNPRM*, released after the CALLS

⁹⁸ *LEC Price Cap Order*, 5 FCC Rcd at 6795-6801, paras. 74-119.

⁹⁹ *Id.*, 5 FCC Rcd at 6792, 6807-10, paras. 48, 166-90. Exogenous costs are incurred due to administrative, legislative, or judicial action beyond the LEC’s control. *See id.* at 6807, para. 166.

¹⁰⁰ *Id.*, 5 FCC Rcd at 6795-6801, paras. 74-119.

¹⁰¹ *Id.*, 5 FCC Rcd at 6801-02, paras. 122-26.

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ *Price Cap Performance Review for Local Exchange Carriers*, First Report and Order in CC Docket No. 94-1, 10 FCC Rcd 8961, 9055, para. 214 (1995) (*1995 Price Cap Review Order*), *aff’d Bell Atlantic Tel. Cos. v. FCC*, 79 F.3d 1195 (D.C. Cir. 1996), *recon. denied Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, Order on Reconsideration, 14 FCC Rcd 1684 (1999). These X-factors included a 0.5 percent CPD.

¹⁰⁵ *1997 Price Cap Review Order*, 12 FCC Rcd at 16645, para. 1.

¹⁰⁶ *Id.*, 12 FCC Rcd at 16772-93, App. D. The 1997 staff TFP study calculated the historical productivity growth difference between LECs and the national economy for the period 1986 through 1995. Specifically, it first calculated for each year the difference between LEC TFP change and the national economy TFP change. The study then calculated for each year an input price difference between the change in LEC input prices and nation-wide input prices. The two calculations were summed for each year.

¹⁰⁷ *United States Telecom Ass’n v. FCC*, 188 F.3d 521, 530 (D.C. Cir. 1999).

coalition filed its access charge proposal, the Commission noted that the CALLS proposal would eliminate the need to adjust the X-factor retrospectively in response to the court's remand, or to calculate an X-factor on a going-forward basis.¹⁰⁸ In response to the *1999 Price Cap FNPRM*, commenters proposed X-factors ranging from 3.71 percent to 11.2 percent.¹⁰⁹

34. In the *CALLS Order*, the Commission changed the X-factor from a productivity-based factor to a transitional mechanism that reduced switched access rates to a specific target and lowered special access rates for a specified period of time.¹¹⁰ As noted above, the special access X-factor was set at 3.0 percent in 2000, 6.5 percent for the next three years, and equal to the GDP-PI thereafter, essentially freezing the special access PCI (after accounting for exogenous cost adjustments).¹¹¹

35. In recent years, the BOCs have earned special access accounting rates of return substantially in excess of the prescribed 11.25 rate of return that applies to rate of return LECs. The BOCs' collective average special access accounting rates of return over the last six years (1998-2003) have been 18, 23, 28, 38, 40, and 44 percent, respectively. We seek comment on whether a rate of return in excess of the Commission's prescribed rate of return for rate-of-return LECs is a valid benchmark for determining the need for an X-factor, or an X-factor that is higher than the factor under the CALLS plan or the pre-CALLS price cap regime.¹¹² If it is appropriate for us to examine an X-factor in light of these rates of return, we seek comment on whether we should re-impose a productivity-based X-factor as a method of reducing the special access PCI.

36. We ask parties to submit studies quantifying an appropriate X-factor for special access services. In a previous order, the Commission eliminated the requirement that LECs report the expense matrix data used in calculating the X-factor.¹¹³ The Commission recognized, however, the need for certain information provided by the expense matrix and expected companies to keep such data available and be prepared to provide the data upon request.¹¹⁴ We now request that price cap LECs submit their expense matrix data from 1994 to 2004 (or 2003, if 2004 data are not yet available). These data should correspond exactly to the expense matrix data previously required under Part 32 of the Commission's rules.¹¹⁵

¹⁰⁸ *Price Cap Performance Review for Local Exchange Carriers*, CC Docket Nos. 94-1, 96-262, Further Notice of Proposed Rulemaking, 14 FCC Rcd 19717, 19718, para. 4 (1999) (*1999 Price Cap FNPRM*).

¹⁰⁹ *CALLS Order*, 15 FCC Rcd at 13020, para. 139 (citing USTA Reply at 13 and AT&T Comments at 12-15, respectively).

¹¹⁰ *Id.*, 15 FCC Rcd at 13020-21, para. 140.

¹¹¹ *Id.*, 15 FCC Rcd at 13025, para. 149.

¹¹² See *infra* section III.A.4 (discussing the 11.25 rate of return at greater length).

¹¹³ *Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase I*, CC Docket No. 99-253, Report and Order, 15 FCC Rcd 8690, 8694, para. 7 (2000) (*Phase I Accounting Streamlining Order*).

¹¹⁴ *Id.* These continuing obligations for the LECs to maintain expense matrix data and to provide them to the Commission upon request were approved by the Office of Management and Budget (OMB) on June 19, 2000. See *Notice of Office of Management and Budget Action*, OMB No. 3060-0370 (June 19, 2000). The expense matrix assists in calculation of a productivity offset because it separates labor and material expense, and labor and material prices do not necessarily move together.

¹¹⁵ 47 C.F.R. § 32.5999(f) (1999). The relevant expense categories include (1) Salaries and Wages, (2) Benefits, (3) Rents, (4) Other Expenses, and (5) Clearances. This rule was eliminated in the 2000 *Phase I Accounting Streamlining Order*.

37. Prior to CALLS, the Commission used a single X-factor for every basket of services.¹¹⁶ The special access PCI formula did not, therefore, have a unique X-factor. In the *CALLS Order*, however, the Commission adopted specific special access X-factors.¹¹⁷ In this proceeding, we are examining a price cap method of regulating rates solely for special access services.¹¹⁸ Given that we propose to address special access services independent of switched access services, we seek comment on whether it is necessary to estimate and apply to special access services an X-factor that is unique to these services. Assuming that this is necessary, we seek comment on whether it is possible to calculate accurately such an X-factor. If it is only possible to measure productivity accurately for the entire firm, or for some broader category of services than special access services, we invite commenters to address the reasonableness of applying this broader X-factor to special access services alone. We seek comment on the consequences of using in the special access PCI a productivity factor that is based on a broad-based productivity study such as the staff's TFP study.

b. Growth factor

38. In addition to applying an X-factor that adjusts rates to account for overall LEC productivity gains, the Commission has sometimes applied a growth or “g” factor to account for LEC average cost decreases attributable to demand growth. The X-factor and “g” factor are related price cap tools, but they differ both operationally and conceptually. The X-factor generally is based on a multi-year, multi-company study of total factor productivity. We have applied a uniform X-factor for a multi-year period to all price cap carriers and price cap services. A “g” factor, in contrast, varies by LEC, year, and service because it relies on each individual LEC's prior year's demand growth rate for a specific service element or basket.¹¹⁹ An X-factor may, however, also account for demand growth reflected in scale economies. If we adopt a “g” factor, we would need, therefore, to ensure that the X-factor does not also count demand growth-related efficiencies.

39. In the *LEC Price Cap Order*, the Commission adopted a price cap formula for the common line basket that included a “g” factor. There, because per-minute traffic growth was not directly indicative of per-line cost increases, the Commission developed “g” to represent per-minute growth per access line.¹²⁰ The Commission found that including “g” would give all of the benefits of MOU demand growth to IXCs, while excluding “g” would give all of the benefits of MOU demand growth to LECs.¹²¹ As a compromise, the Commission incorporated g/2 into the PCI formula because it found that both IXCs and LECs contribute to demand growth.¹²² The Commission did not at that time attempt to measure the relative contributions to demand growth made by IXCs and LECs.¹²³

¹¹⁶ See *CALLS Order*, 15 FCC Rcd at 13021, para. 141.

¹¹⁷ *Id.*, 15 FCC Rcd at 13033-34, para. 172.

¹¹⁸ If, for example, we adopt a bill-and-keep compensation system for switched calls in the intercarrier compensation proceeding, switched access rates and therefore a method of regulating these rates may not be necessary. See *Intercarrier Compensation NPRM*, *supra* note 6, 16 FCC Rcd at 9644-45, para. 97.

¹¹⁹ See *infra* section III.A.3 (discussing rate baskets).

¹²⁰ *LEC Price Cap Order*, 5 FCC Rcd at 6793-95, paras. 55-73. The “g” factor for the common line basket was developed to reflect that carrier common line (CCL) rates are imposed on a minute of use (MOU) basis even though common line costs do not vary with MOU. *Id.* The “g” factor is defined as “the ratio of minutes of use per access line during the base period, to minutes of use per access line during the previous period, minus 1.” See 47 C.F.R. § 61.45(c)(1).

¹²¹ *LEC Price Cap Order*, 5 FCC Rcd at 6793-95, paras. 55-73.

¹²² *Id.*

¹²³ *Id.*

40. If we adopt new special access price cap regulation for LECs, it may also be appropriate to include a factor in the special access PCI formula similar to the “g” factor currently in the common line formula. The ARMIS data suggest that special access line demand growth does not produce a proportional increase in special access costs.¹²⁴ In such a circumstance, use of a special access PCI formula that does not include a growth factor may produce unreasonable rates. We therefore invite parties to comment on whether a special access PCI formula should include a growth factor similar to the “g” factor in the common line PCI formula. We also seek comment on how to define a special access line growth factor. For example, should this factor be based on the change in DS-1 equivalent capacity, changes in DS-3 equivalent capacity, or some basis other than capacity equivalents? We seek comment on whether the demand growth benefits reflected in a “g” factor should be shared between the LECs and the special access customers. Finally, parties advocating for a “g” factor should comment on how to avoid including demand growth-related efficiencies in both the “g” factor and the X-factor.

c. Earnings Sharing

41. In the *LEC Price Cap Order*, the Commission established three earnings sharing zones based on specific rates of return.¹²⁵ In the first zone, price cap LECs were allowed to retain all of their earnings up to the first rate of return ceiling, 12.25 or 13.25 percent, depending on whether the LEC elected a 3.3 or 4.3 percent productivity factor.¹²⁶ In the second zone, price cap LECs were allowed to retain 50 percent and return to ratepayers 50 percent of their earnings between the first ceiling and the second ceiling, 16.25 or 17.25 percent, again depending on whether the LEC elected a 3.3 or 4.3 percent productivity factor.¹²⁷ In the third zone, price cap LECs were required to return 100 percent of any earnings above the second ceiling.¹²⁸

42. In the *1995 Price Cap Review Order*, the Commission modified the initial sharing requirements. LECs that elected a productivity factor of 5.3 percent were allowed to retain 100 percent of their earnings.¹²⁹ They were not, however, allowed to make a low-end adjustment to their PCIs if their earnings fell below 10.25 percent.¹³⁰ LECs that did not elect the highest productivity factor were subject to sharing requirements based on rate of return levels: They were allowed to retain all of their earnings up to a rate of return ceiling of 12.25 percent, if they elected either a 4.0 or 4.7 percent productivity factor.¹³¹ They were required to share 50 percent of their earnings between the first ceiling and a second ceiling, 13.25 or 16.25 percent, depending on whether the LEC elected a 4.0 or 4.7 percent productivity factor.¹³² They were required to return 100 percent of any earnings above the second ceiling.¹³³ These LECs were allowed to make a low-end adjustment to their PCIs if their earnings fell below 10.25 percent.

43. In the *1997 Price Cap Review Order*, the Commission eliminated the sharing requirements, finding that sharing severely blunts the incentives of price cap regulation by reducing the rewards for

¹²⁴ See *supra* section III.A.1.

¹²⁵ *LEC Price Cap Order*, 5 FCC Rcd at 6801-02, paras. 122-26.

¹²⁶ *Id.*, 5 FCC Rcd at 6801-02, paras. 123, 126.

¹²⁷ *Id.*, 5 FCC Rcd at 6801-02, paras. 124, 126.

¹²⁸ *Id.*, 5 FCC Rcd at 6801-02, paras. 125-26.

¹²⁹ *1995 Price Cap Review Order*, 10 FCC Rcd at 8970-71, paras. 19-20.

¹³⁰ *Id.*

¹³¹ *Id.*

¹³² *Id.*

¹³³ *Id.*

LEC efficiency gains.¹³⁴ The Commission also found that eliminating sharing requirements removed the last vestige of rate of return regulation that had created incentives to shift costs between services to evade sharing in the interstate jurisdiction.¹³⁵

44. We tentatively conclude, for the same reasons that the Commission eliminated sharing, that we should not now require LECs to share earnings if we decide to adopt a price cap plan for special access services. We seek comment on this tentative conclusion.

d. Low-End Adjustment

45. In the *LEC Price Cap Order*, the Commission adopted a low-end adjustment mechanism applicable to LECs earning below 10.25 percent – more than 100 basis points below the 11.25 carrier prescribed rate of return.¹³⁶ This mechanism ensured that the price cap plan did not subject any LEC to such low earnings over a prolonged period of time so as to grossly impair the LEC's ability to attract capital and to provide services.¹³⁷ The low-end adjustment to the PCI formula permits price cap LECs that earn a rate of return less than 10.25 percent in a given year temporarily to increase their PCIs in the next year to a level that would allow them to earn 10.25 percent.¹³⁸

46. In the *1995 Price Cap Review Order*, as mentioned above, the Commission eliminated the low end adjustment for price cap LECs that elected the highest X-factor and therefore were not required to share any of their earnings.¹³⁹ In the *Pricing Flexibility Order*, the Commission eliminated the low end adjustment mechanism for price cap LECs that qualify for and elect to exercise either Phase I or Phase II pricing flexibility.¹⁴⁰ The Commission retained the low-end adjustment for carriers that have not qualified for and elected to exercise either Phase I or Phase II pricing flexibility to protect these LECs from events beyond their control that would affect earnings to an extraordinary degree.¹⁴¹

47. For the same reason, we tentatively conclude that, if we adopt a price cap plan for special access services, we should retain a low-end adjustment mechanism for LECs that have not implemented pricing flexibility. We seek comment on this tentative conclusion. We further seek comment on the nature of a low-end adjustment for special access services only. We request that parties identify the relationship between the low-end adjustment level and any new authorized rate of return we develop in this proceeding.¹⁴² For example, should the low-end adjustment continue to be 100 basis points below the authorized rate of return?

3. Rate Structure – Interstate Special Access Baskets and Bands

48. A price cap basket is a broad grouping of services, such as special access services. Prices for services in the basket are limited by the PCI for the basket. Placing services together in the same basket

¹³⁴ *1997 Price Cap Review Order*, 12 FCC Rcd at 16700, para. 148.

¹³⁵ *Id.*

¹³⁶ *LEC Price Cap Order*, 5 FCC Rcd at 6806-07, paras. 164-65.

¹³⁷ *Id.*, 5 FCC Rcd at 6804, para. 147.

¹³⁸ *Id.*, 5 FCC Rcd at 6802, para. 127.

¹³⁹ *1995 Price Cap Review Order*, 10 FCC Rcd at 8971, para. 20.

¹⁴⁰ *Pricing Flexibility Order*, 14 FCC Rcd at 14304, para. 162.

¹⁴¹ *CALLS Order*, 15 FCC Rcd at 13037-38, para. 181-82.

¹⁴² *See infra* section III.A.4.

limits LEC pricing flexibility and incentives to shift costs.¹⁴³ Within the special access service basket, services currently are grouped into service categories and subcategories.¹⁴⁴ Similar services are grouped together into service categories within a single basket to act as a substantial bar on the LEC's ability to engage in anticompetitive behavior.¹⁴⁵

49. The rules adopted by the Commission in the *LEC Price Cap Order* established upper and lower pricing bands for each separate category or subcategory.¹⁴⁶ Originally, the pricing bands for most of the service categories were set at five percent above and below the Service Band Index (SBI).¹⁴⁷ In the *1995 Price Cap Performance Review Order*, the Commission increased the lower pricing band to 15 percent for services subject to zone density pricing.¹⁴⁸ Subsequently, the Commission eliminated the lower service band indices, concluding that this would lead to lower prices and encourage LECs to charge rates that reflect the underlying costs of providing exchange access services.¹⁴⁹ It found that the PCI and upper pricing bands adequately control predatory pricing and that greater downward pricing flexibility would benefit consumers both directly through lower prices and indirectly by encouraging only efficient entry.¹⁵⁰

50. We seek comment on what categories and subcategories we should establish in a special access services basket if we adopt a price cap method to regulate special access prices. Should we retain without modification the existing special access categories and subcategories? If not, parties should identify the specific categories and subcategories of special access services that they contend we should adopt. We ask parties to discuss the advantages and disadvantages of having a special access basket with relatively few categories or subcategories compared to one with many.

51. We seek comment on whether to place competitive services and non-competitive services in separate and distinct categories and/or subcategories. Arguably, this would minimize the opportunity for a LEC to offset rate decreases for services for which there are competitive alternatives with rate increases for services for which there are no complete alternatives.¹⁵¹ For instance, AT&T asserts that DS1 and DS3 channel termination services extending between the LEC end office and the customer premises often are subject to little or no competition.¹⁵² AT&T also claims that competition may not be quite so limited

¹⁴³ *LEC Price Cap Order*, 5 FCC Rcd at 6810-11, paras. 198-203.

¹⁴⁴ The special access basket currently contains the following categories or subcategories:

- (i) Voice grade special access, WATS special access, metallic special access, and telegraph special access services;
- (ii) Audio and video services;
- (iii) High capacity special access, and DDS services, including the following subcategories:
 - (A) DS1 special access services; and
 - (B) DS3 special access services;
- (iv) Wideband data and wideband analog services.

47 C.F.R. §61.42(e)(3).

¹⁴⁵ *LEC Price Cap Order*, 5 FCC Rcd at 6811, para. 203.

¹⁴⁶ *Id.*, 5 FCC Rcd at 6813-14, paras. 224-26.

¹⁴⁷ *Id.* The SBI is a subindex of the prices for each category or subcategory.

¹⁴⁸ *1995 Price Cap Review Order*, 10 FCC Rcd at 9141, para. 411.

¹⁴⁹ *Access Charge NPRM, Order, and NOI*, 11 FCC Rcd at 21487-88, para. 305.

¹⁵⁰ *Id.*

¹⁵¹ See *infra* section III.B.1.b.

¹⁵² *AT&T Petition for Rulemaking* at 25-28.

for DS1 and DS3 channel terminations extending between the IXC POP and the LEC serving wire center, and for DS1 and DS3 channel mileage facilities extending between the LEC end office and the LEC serving wiring center.¹⁵³ We seek comment on whether we should establish separate categories for DS1 and/or DS3 special access services and subcategories for (1) special access channel terminations between the LEC end office and the customer premises, (2) special access channel terminations between the IXC POP and the LEC serving wire center, or (3) any other special access product market.¹⁵⁴ Should any special access services be combined into a single category or subcategory? We also seek comment on whether we should take the same approach with regard to high capacity services above the DS-3 level (e.g., OCn), or whether these higher capacity services should be placed in a high capacity category without sub-categories for special access channel terminations to customer premises, special access channel terminations to the IXC POP, and other special access facilities?

52. Some price cap LECs indicate that broadband services, e.g., DSL services, account for a significant and growing portion of their special access revenues.¹⁵⁵ These services generally may be subject to competition from high-speed cable modem or other services provided by cable companies and from wireless broadband offerings.¹⁵⁶ We seek comment on whether to establish a separate category or subcategory for broadband services that are subject to some competition or are likely to be subject to competition in the near future. We note that, in the *LEC Price Cap Order*, the Commission excluded packet-switched services from price cap regulation because they were not included in its study of LEC productivity.¹⁵⁷ We seek comment on whether such services should be included in price caps today. If not, what is the proper regulatory treatment of these services?

53. We seek comment on whether to establish separate subcategories for wholesale services and retail services. Arguably, this approach would minimize the extent to which a price cap LEC could manipulate headroom by offsetting rate decreases that apply to services purchased by a wholesale customer (e.g., a rate decrease for a DS3 channel termination service purchased by an IXC) with rate increases that apply to services purchased by an end-user customer (e.g., a rate increase for a retail DSL service purchased by a small business or residential customer.) We seek comment on whether this objective is desirable.

54. We also seek comment on what criteria and data we should examine to determine which services to place in which categories or subcategories. We ask parties to propose categories or subcategories, to explain in detail the bases for their proposed categories or subcategories, and to support their proposals with data and studies. Do competitive or non-competitive services placed in the same

¹⁵³ AT&T Reply at 23-24 (“[Verizon’s] channel termination portion of the total price for a single 10-mile two-ended DS-3 access circuit increased by 36%, while the transport component remained unchanged. For DS-1 circuits, Verizon increased channel terminations in some Phase II areas by as much as 24%, while increasing transport by only 4%. . . . For example, while Verizon South’s DS3 entrance facility rates in Phase II areas are 13% higher than those in price capped areas, Verizon South’s DS3 channel termination rates in Phase II areas are 71%; higher than in priced cap areas.” (emphasis in original)), Reply Declaration of Lee L. Selwyn at 8-10.

¹⁵⁴ See *infra* section III.B.1.b(i) (discussing that, in the *Pricing Flexibility Order*, the Commission adopted different competitive triggers for these services in recognition of the different degrees of competition that existed for these services).

¹⁵⁵ See Kahn/Taylor Decl. at 14-15.

¹⁵⁶ See generally *Inquiry Concerning the Deployment of Advanced Telecommunications Capability to All Americans in a Reasonable and Timely Fashion, and Possible Steps to Accelerate Such Deployment Pursuant to Section 706 of the Telecommunications Act of 1996*, GN Docket No. 04-54, Fourth Report to Congress, FCC 04-208 (rel. Sept. 9, 2004) (concluding that “advanced telecommunications capability is being deployed on a reasonable and timely basis to all Americans,” and discussing different types of advanced telecommunications facilities).

¹⁵⁷ *LEC Price Cap Order*, 5 FCC Rcd at 6810, para. 195.

subcategory need to have similar demand or supply elasticities? Should we establish separate categories or subcategories based on special access line densities? For example, channel termination services extending between a LEC end office and a customer premise in areas where there are more than 10,000 special access lines per square mile could be placed in a particular subcategory.

55. Rather than establishing a single special access basket with a number of different categories or subcategories, we could establish more than one special access basket each with one or more categories or subcategories. We seek comment on whether to use a single basket or multiple baskets and the advantages and disadvantages of each approach.

56. For the same reasons that the Commission eliminated the lower pricing bands, we tentatively conclude that there should be no lower band for service categories or subcategories to restrict the price cap LECs' downward pricing flexibility. We seek comment on this tentative conclusion.

57. We seek comment on the upper band value to limit the price cap LECs' upward pricing flexibility for the categories or subcategories. Should we retain five percent as the value? Should we use different values for different categories or subcategories? What criteria and data should we use to determine these values?

58. We consider elsewhere in this NPRM whether to modify pricing flexibility.¹⁵⁸ Likewise, we also seek comment elsewhere regarding how services currently subject to pricing flexibility should be treated in the event that we decide that such services should no longer qualify for pricing flexibility.¹⁵⁹

4. Initial Special Access Price Cap Rates Post-CALLS

59. We must ensure that the initial rates under a new price cap plan will be just and reasonable.¹⁶⁰ AT&T, in its petition, asserts that current special access rates are too high, based on the rates of return BOCs have earned on their special access services.¹⁶¹ AT&T also presents evidence purporting to show that current rates for special access services under the existing price cap plan generally are lower than rates established under a grant of pricing flexibility.¹⁶² The BOCs respond that accounting rates of return are meaningless and the Commission expected that rates in some instances would increase when a carrier is granted pricing flexibility.¹⁶³ They also present evidence purporting to show that overall special access revenues per line have decreased.¹⁶⁴ As a preliminary matter, we solicit comment as to whether it is necessary for us to reinitialize rates to ensure they are just and reasonable. To the extent we decide to reinitialize rates, we solicit comment as to several alternative approaches.

60. *Rate of Return Benchmark.* We seek comment on whether the Commission's prescribed 11.25 percent rate of return that applies to rate of return LECs is a valid benchmark for determining whether price cap LECs' special access rates are just and reasonable.¹⁶⁵ The 11.25 percent rate of return was established in 1991.¹⁶⁶ The costs of debt and equity financing that are supposed to be reflected in the

¹⁵⁸ See *infra* section III.B.

¹⁵⁹ See *infra* section III.B.4.

¹⁶⁰ See 47 U.S.C. § 201(b).

¹⁶¹ *AT&T Petition for Rulemaking* at 7-11.

¹⁶² *Id.* at 11-13.

¹⁶³ Kahn/Taylor Decl. at 6-9; Verizon Comments at 24-25.

¹⁶⁴ Kahn/Taylor Decl. at 15-16.

¹⁶⁵ See *infra* section III.A.2.a.

¹⁶⁶ *LEC Price Cap Order*, 5 FCC Rcd at 6814, 6816, paras. 230, 247.

rate of return change over time and likely have changed significantly since 1991. If parties believe that we should use rate of return as a benchmark for determining the reasonableness of price cap LECs' special access rates, is there a rate of return other than 11.25 percent we should use to make that determination? We invite them to submit studies supporting an alternative rate of return.

61. The aim of price cap regulation is rates that approximate those that a competitive firm would charge, and a competitive firm makes decisions based on economic, not accounting rates of return.¹⁶⁷ We note that the BOCs contend that accounting rates of return do not represent a valid basis for evaluating price cap rates.¹⁶⁸ In particular, our cost allocation rules and factors such as the current separations freeze may undermine the usefulness of examining rates of return derived from ARMIS data.¹⁶⁹ Accordingly, we seek comment generally on whether accounting rates of return are meaningful statistics for evaluating the reasonableness of price cap rates. What factors may affect the relevance of ARMIS data to our examination of special access rates?

62. Even if the overall accounting rate of return has evidentiary value for these purposes, we also seek comment on whether an accounting rate of return for a subset of services, *i.e.*, the special access basket of services, is meaningful to this inquiry. LECs incur costs for many assets and activities that are common to supplying multiple services. The allocation of these common costs to multiple services according to our accounting rules necessarily reflects policy judgments that may not reflect how price cap LECs would allocate common costs if they operated in fully competitive markets. Thus we seek comment on the need to evaluate the special access rate of return in the context of the LECs' overall rates of return. We note that the Commission has never examined accounting rates of return for specific categories of services to determine whether a LEC is required to make an exogenous cost adjustment to share over-earnings or whether a LEC is qualified to make a low-end adjustment to compensate it for under-earnings. Instead, the Commission has determined whether such adjustments should be made based on the LEC's overall interstate access rate of return.¹⁷⁰ We therefore seek comment on what measures or indicators we may use in addition to, or in lieu of, rate of return to determine whether current special access rates are just and reasonable. We invite parties to submit any such measures or indicators they deem appropriate.

¹⁶⁷ See Franklin M. Fisher & John J. McGowan, *On the Misuse of Accounting Rates of Return to Infer Monopoly Profits*, 73 AMERICAN ECON. REV. 82, 83 (1983); Thomas E. Copeland & J. Fred Weston, FINANCIAL THEORY AND CORPORATE POLICY 22-25, 28 (3d ed. 1988) ("An economist uses the word *profits* to mean rates of return in excess of the opportunity cost for funds employed in projects of equal risk. To estimate economic profits, one must know the exact time pattern of *cash flows* provided by a project and the opportunity cost of capital. . . . Therefore the appropriate profits for managers to use when making decisions are the discounted stream of cash flows to shareholders. . . . The main difference between the accounting definition and the economic definition of profit is that the former does not focus on cash flows when they occur, whereas the latter does. . . . Financial managers are frequently misled when they focus on the accounting definition of profit, or earnings per share. The objective of the firm is *not* to maximize earnings per share. The correct objective is to maximize shareholders' wealth, which is the price per share that in turn is equivalent to the discounted cash flows of the firm.") (emphasis in original); see also *infra* note 173.

¹⁶⁸ See, e.g., SBC Opposition at 21-22 ("The cost allocations required under the Commission's cost allocation rules, and Part 36 separations in particular, therefore cannot be used to derive the true economic costs of providing a particular service. . . . Either the ARMIS data provide a distorted, and therefore meaningless, picture of the BOCs' rates of return, or switched access rates are unreasonably low."); see also *supra* note 93 and accompanying text.

¹⁶⁹ See, e.g., SBC Opposition at 21-22; see also *Jurisdictional Separations and Referral to the Federal-State Joint Board*, CC Docket No. 80-286, Report and Order, 16 FCC Rcd 11382 (2001).

¹⁷⁰ See, e.g., *LEC Price Cap Order*, 5 FCC Rcd at 6805, para. 151; *Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, Order on Reconsideration, 6 FCC Rcd 2637, 2381, at para. 97 (1991) (subsequent history omitted).

63. A potential issue with using the accounting rate of return solely for the special access basket is the recent significant growth in BOC DSL subscribers and revenues. Some BOCs may book the full amount of DSL revenues as special access revenues.¹⁷¹ At the same time, the incremental cost booked to the special access category for DSL service may not be nearly as large as these DSL revenues. There generally are no incremental DSL-related loop-side structure costs (e.g., costs for trenching, poles, manholes, or conduit), which otherwise account for a large majority of a typical LEC's total network costs, booked to the special access category. We seek comment on the impact of the growth in DSL service revenues, expenses, and investment on price cap LECs' special access rates of return. To what extent does the accounting treatment of DSL revenues, expenses, and investment under the Commission's rules account for the BOCs' recent high special access rates of return? If DSL growth is a significant factor in the high accounting special access rates of return, rather than growth in traditional DS1 or DS3 services, for example, how should we interpret these rates of return?

64. We seek comment on the need for a comprehensive review of detailed cost studies to establish initial rate levels for each special access service. Alternatively, is there a simpler, less burdensome method of setting initial rate levels without having to rely on cost studies? For example, some parties propose that we develop initial rates based on an 11.25 percent rate of return.¹⁷² To do so, we would (1) calculate, for the most recent calendar year, a price cap LEC's special access rate of return, based on ARMIS data; (2) calculate the percentage by which revenues would have had to have been lower to earn an 11.25 percent rate of return; (3) reduce that price cap LEC's current special access rates across the board by that percentage; and (4) use these reduced rates as the initial rates under a new price cap plan. We seek comment on this approach to establishing just and reasonable initial rates, on variants of this approach, and on other approaches that avoid use of cost studies.

65. *Cost Studies.* Parties commenting that we should use detailed cost studies to set initial special access rates under a new price cap plan should also comment on whether such studies should be based on historical accounting costs, i.e., embedded costs, or forward-looking economic costs. As an initial matter, forward-looking costs are generally viewed as more relevant to setting prices in a competitive market. Embedded costs associated with past business decisions generally are irrelevant to a rational profit-maximizing firm operating in a competitive market; only forward-looking costs matter to such a firm with regard to business decisions that it is required to make today.¹⁷³ Further, as noted above, in the *Access Charge Reform Order*, the Commission stated its goal that interstate access charges reflect the forward-looking costs of providing those services.¹⁷⁴ The Commission subsequently stated that it envisioned conducting a proceeding as the CALLS plan nears its end to determine whether and to what

¹⁷¹ Some BOCs apparently offer DSL services exclusively through a separate subsidiary, in which case no DSL revenues, expenses, or investment are booked to the interstate special access category. See Kahn/Taylor Decl. at 14-15; BellSouth Comments at 5-6; Qwest Comments at 12.

¹⁷² See *AT&T Rulemaking Petition* at 39; Letter from Colleen Boothby, Counsel for Ad Hoc Telecommunications Users Committee, to Marlene H. Dortch, Sec'y, Federal Communications Commission, RM-10593, Att. (Economics and Technology, Inc., *Competition in Access Markets: Reality or Illusion – A Proposal for Regulating Uncertain Markets*) at 7-8 (filed Aug. 26, 2004).

¹⁷³ See Alfred E. Kahn, Timothy J. Tardiff, & Dennis L. Weisman, *The Telecommunications Act at Three Years: An Economic Evaluation of Its Implementation by the Federal Communications Commission*, 11 INFO. AND ECON. POLICY 319, 324-25 (1999) (“Among economists, there is widespread agreement in principle that (1) the costs that would be the basis for efficient prices would be forward-looking, rather than historical and (2) the prices set on that basis should emulate the ones that would emerge from local exchange competition, if it were feasible.”); Armen A. Alchian & William R. Allen, EXCHANGE AND PRODUCTION 222 (3d ed. 1983) (“Once [an item] is acquired, [its costs are] irrelevant to the setting of price in competitive markets.”); N. Gregory Mankiw, PRINCIPLES OF ECONOMICS 291 (1997) (“The irrelevance of sunk costs explains how real businesses make decisions.”); Paul A. Samuelson & William D. Nordhaus, ECONOMICS 167, (16th ed. 1998).

¹⁷⁴ *Access Charge Reform Order*, 12 FCC Rcd at 16001-03, 16092-100, paras. 42-49, 258-74.

degree it could deregulate price cap LECs to reflect the existence of competition.¹⁷⁵ We seek comment on whether setting rates based on forward-looking costs, as suggested in the *Access Charge Reform Order* and in the *CALLS Order*, should guide us in selecting a method to set initial rates under a new special access price cap plan. Parties that support the use of historical costs rather than forward-looking costs should comment on and submit calculations showing the magnitude of any difference between the implied depreciation expense in LECs' special access actual realized revenues and regulatory accounting depreciation expense calculated pursuant to the Commission's rules during the price cap years.¹⁷⁶ If the implied depreciation expense significantly exceeds the regulatory accounting depreciation expense, in setting the initial rates would we need to adjust downward the ratebase to avoid the eventual over-recovery of the original cost of the LECs' assets? Further, any party that supports the use of a cost study, forward-looking or historical, to set rates should submit such a study and support its use of that particular type of study.

66. *Use of Comparable Services.* Some special access services are comparable to switched access transport services. For example, a special access channel termination service extending between an IXC POP and a LEC serving wire center is comparable to a switched access entrance facility. We therefore seek comment on whether setting initial special access prices under a new price cap plan at levels equal to current prices for comparable switched access transport prices would result in just and reasonable rates. Parties should address whether this approach is improperly circular, given that some transport rates, e.g., direct trunked transport rates, were presumed reasonable by the Commission in the *First Transport Order* if they were set based on rates for comparable special access services.¹⁷⁷ Such an approach may be feasible for some services, e.g., DS1 or DS3 special access services, but not necessarily for all special access services. Assuming that this approach is reasonable for some subset of special access services, we ask for comment on how to establish initial just and reasonable rates for the remaining special access services. For example, is it reasonable to establish rates for the remaining services by adding to the rate for the comparable switched access transport service the percentage difference or the dollar differences between the current rate for comparable special access service and the current rate for the non-comparable special access service? We request that parties that believe that initial rates, in whole or in part, should be based on rates for comparable switched access transport services submit such studies.

67. *Incentives.* We seek comment on whether, in determining whether special access rates will be just and reasonable, we should consider as a significant factor the risk of reducing price cap LECs' incentives to operate at minimum cost and to innovate under future price cap plans. Specifically, we question the effect of reallocating benefits resulting from LEC efforts to minimize costs and innovate under the existing price cap plan on LEC expectations of future regulatory action. We seek comment on the potential effect of reducing current rates in the first year of a new price cap plan on incumbent LEC incentives to operate efficiently and to innovate.

68. *Periodic Adjustment.* We further seek comment on whether a new price cap plan should include a requirement that rates be adjusted up or down at fixed intervals (e.g., every three or five years) based on the prescribed rate of return, or some other measure of price cap LEC performance. For example, under one variant of such a price cap plan, LECs would not be required to share any earnings in

¹⁷⁵ *CALLS Order*, 15 FCC Rcd at 12977, para. 36.

¹⁷⁶ By implied depreciation we mean total booked revenues less total booked expenses (excluding accounting depreciation expense) less an 11.25 percent rate of return on the rate base, expressed in dollars. The implied depreciation expense reflected in the actual realized revenues may exceed the regulatory accounting depreciation expense if the actual realized rate of return on the ratebase exceeds 11.25 percent.

¹⁷⁷ *Transport Rate Structure and Pricing*, CC Docket No. 91-213, Report and Order and Further Notice of Proposed Rulemaking, 7 FCC Rcd 7006, 7023-38, paras. 33-59 (1992), *aff'd in pertinent part, rev'd in part Competitive Telecommunications Ass'n v. FCC*, 87 F.3d 522 (D.C. Cir. 1996).

excess of the prescribed rate of return, and generally the core elements of the plan (*e.g.*, the productivity factor) would remain constant throughout the specified interval. If a price cap LEC's achieved rate of return (or other performance measure) were greater or lesser than the prescribed rate of return (or other performance benchmark) by a predetermined amount during the interval, then rates would be adjusted down or up at the beginning of the next interval. At the beginning of the latter interval, the adjusted rates would reflect the prescribed rate of return or other performance benchmark. We seek comment on whether to adopt such an adjustment mechanism in a price cap plan. We also seek comment on how such a plan would affect LEC incentives to operate efficiently and to innovate. How would LEC incentives under such a plan differ from the incentive effects of a plan that included an earnings sharing requirement (*i.e.* required LECs to share earnings in excess of the prescribed rate of return by adjusting rates downward in the year immediately following the year in which they over-earned)? Parties supporting this type of adjustment should provide the operational details of their proposed plan, including specifying the length of the interval that should be used under any such plan. We also seek comment on other variants of an approach that would require rate adjustments at fixed intervals to target the prescribed rate of return, or other performance benchmark.

B. Pricing Flexibility

69. In the *Pricing Flexibility Order*, the Commission relied on the harm caused by unnecessary regulation and on its predictive judgment to adopt anticipatorily deregulatory rules.¹⁷⁸ Essentially, the Commission determined that irreversible, sunk investment by competitive carriers in the special access market, as evidenced by the satisfaction of certain collocation and competitive transport facilities deployment triggers, demonstrates sufficient competitive market entry in specific geographic markets to constrain monopoly behavior, including exclusionary conduct, by price cap LECs.¹⁷⁹ That is, while acknowledging that the incumbent carriers might enjoy high market shares at the time pricing flexibility is granted, the Commission concluded that they could not exercise market power where they faced competition from entrants using their own facilities. The Commission relied on the collocation-based triggers rather than performing a market power analysis because market power analyses would be overly burdensome on parties and on the Commission's limited resources.¹⁸⁰

70. In adopting pricing flexibility, the Commission created a deregulatory regime to enable price cap LECs to respond flexibly to market forces.¹⁸¹ In particular, pricing flexibility provided price cap LECs with the ability to lower rates in specific markets (*i.e.*, MSAs) in response to competitive pressures in those markets.¹⁸² In the *AT&T Petition for Rulemaking*, and in competitive LEC and user group comments in response thereto, parties have introduced evidence that the price cap LECs have not used this flexibility to lower special access rates in any MSA for which they have received Phase II pricing flexibility. Instead, these parties contend that the price cap LECs have either maintained or raised rates in each of these MSAs.¹⁸³

71. As part of our examination of the proper price cap special access regulatory regime to adopt post-CALLS, therefore, we also examine whether the Commission's pricing flexibility rules have worked as intended and, if not, whether they should be modified or repealed. We thus grant the *AT&T Petition for Rulemaking*, in part, inasmuch as we are initiating a rulemaking proceeding. This inquiry is consistent

¹⁷⁸ *Pricing Flexibility Order*, 14 FCC Rcd at 14301, para. 154.

¹⁷⁹ *See id.*, 14 FCC Rcd at 14225, 14258-59, paras. 3, 69-70.

¹⁸⁰ *Id.*, 14 FCC Rcd at 14258, 14268-69, paras. 69, 84-86.

¹⁸¹ *See id.*, 14 FCC Rcd at 14257-58, paras. 68.

¹⁸² *See id.*, 14 FCC Rcd at 14257-58, 14260, 14301, paras. 67-69, 72-74, 153-54.

¹⁸³ *See, e.g., AT&T Petition for Rulemaking* at 11-12; WorldCom Comments at 7-8.

with our ongoing commitment to ensure that our rules, particularly those based on predictive judgments, remain consistent with the public interest as evidenced by empirical data.¹⁸⁴ We note that our questions below are focused on Phase II, not Phase I, pricing flexibility because, once Phase II flexibility is granted, price cap LECs no longer need make available their generally available price cap tariffs.

72. In seeking comment on the specifics of the pricing flexibility rules, we also provide background regarding methods of assessing competition (short of conducting a burdensome market-by-market market power analysis) and on the type of information that would be most useful in evaluating assessments of the levels of competition. As a threshold matter, parties providing information regarding the rates they are charging or paying for special access services should identify whether the rates they identify are from the LEC's price cap tariff, a contract tariff, or a Phase II pricing flexibility tariff. Parties also should identify the percentage of special access services (by market) that are provided or obtained, as the case may be, from each of these three types of tariffs. We further request that parties identify whether the rates are the month-to-month rates or volume and term rates from the relevant tariff. Finally, although this NPRM focuses on special access services, we note that the *Pricing Flexibility Order* treats dedicated transport services (*i.e.*, entrance facilities, direct-trunked transport, and the flat-rated portion of tandem-switched transport) in the same manner as non-channel termination special access services.¹⁸⁵ We, therefore, tentatively conclude that any changes we make to the pricing flexibility rules for non-channel termination special access services shall apply equally to the pricing flexibility rules for dedicated transport. We seek comment on this tentative conclusion.

1. Assessing Competition in the Marketplace

73. There are two basic issues generally relevant to assessing the state of competition in a market (regardless of whether a full market power analysis or a less burdensome analysis is performed). First, if a market is (or is presumed to be) competitive *ex ante*, the level of competition can be assessed by determining whether there have been *substantial* and *sustained* price increases.¹⁸⁶ Second, because the characteristics of different markets vary, an analysis of the level of competition should also include an examination of the cost functions of the industry at issue.¹⁸⁷ In analyzing each issue, both the product or service market (*e.g.*, interstate special access services) and the relevant geographic market (*e.g.*, MSAs) should be well-defined.

a. Substantial and Sustained Price Increase

74. The first step in measuring the level of competition in this proceeding is to determine whether there are substantial and sustained price increases for interstate special access services in well-defined markets.¹⁸⁸ Some parties claim that price cap LECs have increased interstate special access rates in some of the MSAs for which the LECs have received Phase II pricing flexibility.¹⁸⁹ We ask these and other interested parties to provide more recent data that demonstrate whether or not substantial and sustained

¹⁸⁴ See *supra* notes 10 and 11 and accompanying text.

¹⁸⁵ See *Pricing Flexibility Order*, 14 FCC Rcd at 14273-74, 14299, paras. 93-94, 148.

¹⁸⁶ See Daniel F. Spulber, REGULATION AND MARKETS 138-58 (1989).

¹⁸⁷ See John Sutton, SUNK COSTS AND MARKET STRUCTURE 1-82 (1995).

¹⁸⁸ A substantial price increase need not be a large increase. For example, the Department of Justice and Federal Trade Commission Horizontal Merger Guidelines are designed to determine if a merger will result in "a small but significant non-transitory" price increase" in the relevant product market. See United States Department of Justice and Federal Trade Commission Horizontal Merger Guidelines § 1.11 (revised 1997) (DOJ Merger Guidelines).

¹⁸⁹ See, *e.g.*, *AT&T Petition for Rulemaking* at 21-22; WorldCom Comments at 5.

special access price increases have occurred in Phase II MSAs.¹⁹⁰ Parties submitting such data should show not just the price changes that occurred after Phase II pricing flexibility was granted, but whether the rate changes were substantial (*i.e.*, did or did not result in rates above just and reasonable levels). In order to identify whether there have been substantial increases in special access rates, we ask parties to establish an objective benchmark against which to measure the most recent rate level data. Parties should justify and explain, not merely assert, the usefulness of that benchmark.¹⁹¹

75. Parties should then provide a measurement of the sustainability of the rate changes. Sustainability demonstrates whether the firm is, in fact, able to exercise market power. If the firm is unable to maintain a substantial rate increase, for example because another firm enters the market and offers the good or service at a lower rate, then the rate increase is not sustainable and the original firm does not possess market power.

76. We ask parties to comment on whether Phase II pricing flexibility for special access has produced substantial and sustained price increases in those MSAs for which Phase II pricing flexibility was granted. The BOCs maintain that their recent years' special access revenue increases result from high special access demand growth, rather than from high and sustained special access rates.¹⁹² Moreover, the BOCs claim that special access revenue per line evidences a declining trend;¹⁹³ however, we do not have sufficient information to evaluate that claim. Information that would be useful to validate these BOC claims would include price cap LECs' calculations of an Average Price Index (API) for all special access services (including those under price cap and those under pricing flexibility); a Service Band Index (SBI) for each special access service category and subcategory; and the revenues associated with the API and SBIs. In the Commission's annual access tariff review process, price cap LECs file APIs, SBIs, and associated revenues for the special access basket. These calculations exclude rates and revenues for special access services provided in MSAs where pricing flexibility has been exercised. In providing such information, price cap LECs should recalculate these figures using the Tariff Review Plan RTE-1 and IND-1 electronic formats, beginning in the year 2000, for all special access services including services removed from price caps under our pricing flexibility rules.¹⁹⁴ This information would be of significant benefit to our analysis.

77. We also invite parties to support claims of substantial and sustained price increases by identifying the product market (*e.g.*, channel terminations between LEC end offices and customer premises), the customer segment (*e.g.*, businesses in large or medium-sized buildings; large companies or small companies), or any other more detailed demarcation of the special access market in which these price increases occur. We thus take this opportunity to invite parties to proffer evidence regarding whether the predictive judgments on which Phase II pricing flexibility was granted are supported by subsequent marketplace developments.

¹⁹⁰ For example, the data relied on by AT&T were from 1996 through 2001. *See AT&T Petition for Rulemaking*, Declaration of Stephen Friedlander, Exhs. 1, 2. Similarly, WorldCom introduced data from 1999 and 2001. *See WorldCom Reply*, Declaration of Michael D. Pelcovits (Pelcovits Decl.) at 12-15.

¹⁹¹ Parties that critique the benchmark proposed by other parties (for example, in reply comments) should, in addition to the critique, propose an alternative benchmark. Similarly, parties that critique data purporting to show substantial rate increases should explain in detail why the rate increases should not be considered substantial.

¹⁹² *See Kahn/Taylor Decl.* at 15.

¹⁹³ *See id.*

¹⁹⁴ Price cap LECs should perform these API and SBI calculations for all special access services, categories, and subcategories in a manner consistent with sections 61.46 and 61.47 of our rules. *See* 47 C.F.R. §§ 61.46, 61.47.

b. Determination of Level of Market Competitiveness

78. In addition to determining the existence of substantial and sustained special access rate increases that are significantly correlated with grant of Phase II pricing flexibility, analysis of whether services are subject to substantial competition considers an analysis of the cost functions on the industry. This may include analyses of the relevant product market, geographic market, demand responsiveness, supply responsiveness, market share, entry barriers, and other pricing behavior in well-specified markets.

79. In the *Pricing Flexibility Order*, the Commission relied on entry barriers and supply responsiveness analyses to develop the competitive triggers. The Commission determined that, if price cap LECs receive pricing flexibility and raise rates excessively, competitors will enter the market.¹⁹⁵ In so doing, competitors will provide additional supply of special access services at (presumably) lower prices than the incumbent.¹⁹⁶ This rationale represents a supply responsiveness assessment of the level of competition. The Commission also determined that if competitors make a significant amount of irreversible, sunk investment (specifically in collocation and transport facilities), this would signify that entry barriers in that market have been overcome.¹⁹⁷ The Commission found it unnecessary to perform additional forms of market competitive analysis, concluding generally that such analyses would be unduly burdensome.¹⁹⁸

80. We seek comment on whether our pricing flexibility rules reflect a sufficiently robust assessment of the level of interstate special access competition. Parties should address whether actual marketplace developments have validated the supply responsiveness and entry barrier predictive judgments made in the *Pricing Flexibility Order*, and, if not, whether different supply responsiveness and entry barrier assessments are necessary. Parties should also address whether, in assessing our pricing flexibility regime, we should consider additional measures of competition, such as demand responsiveness and the other analytic methods discussed below.

(i) Relevant Product Market

81. For the purposes of re-examining the pricing flexibility rules, we examine the relevant product market.¹⁹⁹ In the *Pricing Flexibility Order*, the Commission identified three categories of product markets for special access services: (1) special access channel terminations between a LEC's end office

¹⁹⁵ *Pricing Flexibility Order*, 14 FCC Rcd at 14297-98, para. 144.

¹⁹⁶ *See id.*

¹⁹⁷ *See id.*, 14 FCC Rcd at 14263-64, paras. 79-80. The Commission did not address whether price cap LECs had enacted a substantial and sustained rate increase because the special access market was then regulated as a monopoly market. Price cap (and rate-of-return) regulation is based on the assumption that the market is a monopoly market. To limit monopoly rents and prevent the societal harms that would result, the Commission attempts to regulate the monopolist in such a manner as to, as best as possible, cause the monopolist to behave as if it were in a competitive market. *See generally* David E. M. Sappington & Dennis L. Weisman, DESIGNING INCENTIVE REGULATION FOR THE TELECOMMUNICATIONS INDUSTRY 1-4 (1996).

¹⁹⁸ *See Pricing Flexibility Order*, 14 FCC Rcd at 14268-73, paras. 84-92.

¹⁹⁹ *See Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area*, CC Docket Nos. 96-149, 96-61, Second Report and Order in CC Docket No. 96-149 and Third Report and Order in CC Docket No. 96-61, 12 FCC Rcd 15756, 15782, para. 41 n.119 (1997) (*LEC Classification Order*) (“[I]n defining the relevant product market, one must examine whether a ‘small but significant and non-transitory’ increase in the price of the relevant product would cause enough buyers to shift their purchases to a second product, so as to make the price increase unprofitable. If so, the two products should be considered in the same product market.”) (internal citation omitted).

and customer premises, (2) special access channel terminations between an IXC POP and a LEC service wire center, and (3) other special access facilities.²⁰⁰

82. We seek comment on whether these are the relevant product markets. For example, commenters should specifically address whether channel terminations from the LEC end office to the customer premises constitute a separate and distinct product market. Parties argue that alternative competitive LEC channel terminations between an IXC POP and a LEC serving wire center or alternative dedicated transport facilities poorly measure the presence of competition for channel terminations between the LEC office and the customer premise.²⁰¹ With regard to the latter, parties argue that a price cap LEC can theoretically be free from all rate regulation applicable to these special access channel terminations when it may, in fact, be the only provider of these special access channel terminations in an MSA where Phase II pricing flexibility has been granted.²⁰² In the *Pricing Flexibility Order*, the Commission acknowledged the economics of channel terminations between the LEC office and the customer premise make it more costly for new entrants to compete in this product market.²⁰³ For this reason, the Commission adopted higher triggers that incumbent LECs must satisfy in order to obtain Phase II pricing flexibility for special access channel terminations between the LEC office and the customer premise. We ask parties to refresh the record and address whether there have been substantial and sustained rate increases since pricing flexibility was granted for channel terminations between LEC offices and customer premises. We ask parties to address the degree of competition that exists for special access channel termination services, including any available quantification of market developments after Phase II pricing flexibility was granted. Because Phase II pricing flexibility is a statistically significant variable in explaining substantial and sustained special access rates, parties should show that pricing behavior changed significantly when and where Phase II pricing flexibility was granted.

83. We seek comment on whether product markets should be further subdivided by transmission capacity. For example, parties should comment (and provide data supporting their positions) on whether DS-1 special access channel terminations between the customer premises and the LEC end office is in the same product market(s) as DS-3 and OCn channel terminations.

²⁰⁰ See *Pricing Flexibility Order*, 14 FCC Rcd at 14234-35, 14273-74, 14278-81, 14299-300, paras. 24-25, 93, 100-07, 148-50.

²⁰¹ See, e.g., WorldCom Comments at 8.

²⁰² See *id.* at 8-9; AT&T Reply at 14.

²⁰³ *Pricing Flexibility Order*, 14 FCC Rcd at 14299-300, para. 150. The Commission explained the need for higher trigger thresholds for these channel terminations as follows:

[C]hannel terminations between a LEC end office and a customer premises warrant different treatment than other special access and dedicated transport services. . . . We agree that pricing flexibility for channel terminations between a LEC end office and a customer premises requires a higher threshold than flexibility for other dedicated transport and special access services. Entrance facilities, direct-trunked transport, channel mileage, and the flat-rated portion of tandem-switched transport all involve carrying traffic from one point of traffic concentration to another. Thus, entering the market for these services requires less investment per unit of traffic than is required, for example, for channel terminations between an end office and customer premises. Furthermore, investment in entrance facilities enables competitors to provide service to several end users, while channel terminations between an end office and customer premises serve only a single end user. Accordingly, competitors are likely to enter the market for entrance facilities, direct-trunked transport, channel mileage, and the flat-rated portion of tandem-switched transport before they enter the market for channel terminations between a LEC end office and a customer premises. We therefore adopt a higher threshold for granting flexibility for these channel terminations than for other special access and dedicated transport services.

Id. at 14278-79, paras. 101-02 (internal citation omitted).

84. Although we have not previously defined the classes of customers that obtain special access services (such as classifying customers by the annual revenue per building or by the capacity required to serve them), a careful differentiation among customer classes may be important for a thorough level of competition analysis.²⁰⁴ It may be relevant, for example, whether special access customers, such as CMRS providers, IXCs, or enterprise business customers, constitute one or multiple customer class(es). Parties should support, as much as possible, their proposed relevant customer classes with reliable empirical data.²⁰⁵

85. In discussing the relevant product markets, we ask parties to consider not only special access services provided over price cap incumbent LEC networks, but also whether facilities provided over other platforms, *e.g.*, cable, wireless, and satellite, as well as over competitive LEC self-provisioned wireline facilities, could provide the equivalent of price cap LEC special access services. We seek comment on the willingness and ability of users to purchase equivalent special access services as substitutes for a price cap LEC's special access services. In this regard, we ask parties to discuss whether significant intermodal special access price and quality service differentials exist and, if so, whether that implies that these services are in different product markets.

86. Finally, in determining the appropriate delineation of the product market in which to perform this analysis, we ask parties to provide their analyses consistent with their proposed geographic market.

(ii) Geographic Market

87. To define the relevant market, we typically determine not only the relevant product market, but also the relevant geographic market(s).²⁰⁶ The Commission previously has identified the relevant geographic market for granting pricing flexibility for special access services as the MSA.²⁰⁷ We seek comment on whether this remains the appropriate geographic market for each of the special access services product markets, identified above or by commenting parties.

88. Some parties claim that competition is concentrated in a small number of areas within MSAs and that, therefore, the MSA is too large to be the relevant geographic market.²⁰⁸ They allege that a pricing flexibility trigger based on collocation coupled with competitive transport does not consider the ubiquity of competitive transport facilities throughout an MSA.²⁰⁹ They thus contend that the trigger may demonstrate that numerous carriers have provisioned transport from their switches to collocation arrangements in a single wire center, such as a LEC serving wire center, but the trigger does not demonstrate the existence of competitive transport to interconnect the collocation arrangements to similar arrangements in any other price cap LEC wire centers. If, for example, a collocated competitor uses its own transport to carry traffic from a LEC serving wire center to an IXC POP, this may establish competition for this facility, but it is not sufficient to establish competition for other special access services. In short, these parties conclude that the Commission's trigger does not say enough about the geographic extent of "irreversible sunk investments" by competitors throughout the MSA in which pricing flexibility was granted. As a result, they argue, incumbent LECs may be able to exercise

²⁰⁴ See DOJ Merger Guidelines § 2.22.

²⁰⁵ Such data, for example, may include econometric estimates of cross elasticity of demand or marketing studies that show consumer substitutability of demand for competing services.

²⁰⁶ See DOJ Merger Guidelines § 1.2.

²⁰⁷ *Pricing Flexibility Order*, 14 FCC Rcd at 14260, paras. 72-74.

²⁰⁸ See, *e.g.*, AT&T Reply, Reply Declaration of Lee L. Selwyn at paras. 16-21.

²⁰⁹ See, *e.g.*, *Revisions by Qwest Corporation to Tariff F.C.C. No. 1*, Transmittal No. 206, Petition of Time Warner Telecom to Reject, or Alternatively, Suspend and Investigate at 4-5 (filed Aug. 23, 2004).

monopoly power through the use of exclusionary pricing strategies in some portions of the MSA. We seek comment on these contentions.

89. We note that all of the price cap LECs' special access pricing flexibility petitions to date have relied on the alternative trigger regarding the percentage of revenue associated with wire center collocation as opposed to the trigger that measures only the percentage of wire centers with collocation.²¹⁰ Because the revenue triggers require collocation, and hence facilities deployment, in fewer wire centers in the MSA, we invite commenters to address whether the MSA remains a reasonable geographic market in which to measure irreversible sunk investment in the relevant special access product markets, and particularly for channel terminations between the LEC office and the customer premise. We seek comment on this concern.

90. One reason that competition may not develop throughout an entire MSA is that the difference between the expected per unit costs of any potential competitor and a price cap incumbent LEC's expected per unit costs in the foreseeable future may be considerably greater in some areas of an MSA than others. Any such cost disadvantages may be smaller in areas of relatively high special access line density, e.g., downtown Boston, than in areas of relatively low density, e.g., suburban Boston. We seek comment on the degree to which special access line density affects the cost disadvantage a potential entrant would face relative to a price cap LEC, and the reasons for this disadvantage, if any exists. We also seek comment on the use of some measure of special access line density to refine the relevant geographic market definition for special access services. Under one approach, line density might be used to subdivide, not supplant, the MSA geographic market. Under a second approach, line density might replace the MSA as the relevant geographic market. We seek comment on these approaches.

91. If we were to use line density to define the geographic market, we would have to establish density zones. We request comment on how to establish density zones for purposes of defining the relevant geographic market. In this regard, we note that states generally are required to de-average state-wide UNE rates into at least three zones to reflect costs differences within the state.²¹¹ Most states, at a minimum, have established rate zones for voice grade loops and DS1 loops. Some states also have established rate zones for UNE loops with capacities higher than DS1 and for dedicated transport and entrance facility UNEs with various capacities. We ask parties to comment on whether it would be appropriate to use the rate zones already established by the states for comparable UNEs as the density zones for interstate special access services. In this regard, we seek comment on the comparability of UNEs and special access services. For example, if a state does not de-average the rate for DS3 UNE loops, is it appropriate to use zones that it established for DS1 loops for the DS3 special access service zones? Or if a state does not de-average rates for dedicated transport or entrance facility UNEs, is it appropriate to use the zones that it established for DS1 loops as the density zones for interoffice special access services? More generally, is it necessary to establish different sets of density zones for special access channel termination services extending between the LEC's end office and the end user, for channel

²¹⁰ E.g., *BellSouth Petition for Pricing Flexibility for Special Access and Dedicated Transport Services*, CCB/CPD File No. 00-20, Memorandum Opinion and Order, 15 FCC Rcd 24588 (CCB 2000); see also *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, Deployment of Wireline Services Offering Advanced Telecommunications Capability*, CC Docket Nos. 01-338, 96-98, 98-147, Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, 18 FCC Rcd 16978, 17182-83, para. 341 (2003) (*Triennial Review Order*) (subsequent history omitted) ("Incumbent LECs have received special access pricing flexibility in numerous MSAs throughout their regions, based almost exclusively on meeting the *Pricing Flexibility Order's* triggers based on special access revenues.").

²¹¹ 47 C.F.R. § 51.507(f); *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98, 95-185, First Report and Order, 11 FCC Rcd 15499, 15882-82, paras. 764-765 (1996) (*Local Competition Order*) (subsequent history omitted).

termination service extending between the LEC's serving wire center and the IXC POP, and for interoffice facilities?

92. We also seek comment on alternative ways that we might develop density zones for special access rates. We ask parties to define the appropriate measure of special access line density. Should we measure density, for example, based on price cap incumbent LEC DS0-equivalent special access lines per square mile, DS1 lines per square mile, DS3 lines per square mile, or on some other basis? We also request comment on how to group line densities, *e.g.*, 10,000 DS0-equivalent special access lines and above, 1,000 DS0-equivalent lines and below. We request that parties propose density zones for special access service. Parties that propose these zones should demonstrate why these zones would reflect varying degrees of special access competition.

93. Finally, we seek comment on how to apply any triggers that we adopt for pricing flexibility if we adopt density zones to define geographic markets for special access services. If we retain use of collocation as a trigger, for example, is there some special access line density level that is so high, *e.g.*, 10,000 lines or greater per square mile, that it would enable us to conclude that it is unnecessary to examine data regarding the presence of collocation facilities? Or, if we use density zones to define geographic markets and collocation presence as a trigger, should the amount of collocation required vary inversely with special access line density within a zone? For example, could we grant pricing flexibility where there is relatively low amount of collocation in a relatively high density zone or where there is a relatively high amount of collocation in a relatively low density zone?

(iii) Demand Responsiveness

94. Parties may seek to demonstrate that the market for a particular special access service is not competitive by showing that a significant number of the price cap incumbent LEC's customers do not have the ability to purchase a full range of comparable special access services from carriers other than the LEC. Economists traditionally measure demand responsiveness by identifying other special access options, relevant to that particular market, that are close substitutes, and determining whether consumers are impeded from switching to these substitutes.²¹²

95. Although the Commission did not address demand responsiveness in the *Pricing Flexibility Order*, the demand responsiveness of a price cap incumbent LEC's customers may be an important factor in assessing the level of competition for incumbent special access services. In providing a demand-response analysis, parties should show whether the demand responsiveness before and after pricing flexibility was granted differed significantly. Parties should also show whether this response is significantly different, *ceteris paribus*, between an MSA in which Phase II pricing flexibility has not been granted and an MSA in which it has.

96. Because an MSA-by-MSA, service-by-service, customer-class-by-customer-class demand-response analysis may be unduly burdensome to parties and to the Commission, parties may aggregate demand-response data, statistics, and analyses.²¹³ We are concerned, however, that too much aggregation may lead to inconclusive results. For example, because we have emphasized distinctions between product markets (*e.g.*, special access channel terminations between the customer premise and the LEC office, special access channel terminations between the IXC POP and the LEC serving wire center, and other special access services), we ask parties not to aggregate data from these markets. Also, we request that

²¹² More specifically, demand responsiveness measures the sensitivity of the quantity demanded to price changes. Demand responsiveness is typically measured by the elasticity of demand, which is the percentage change in the quantity demanded for a particular product will be following a one percent change in the price of that product. See Robert S. Pindyck & Daniel L. Rubinfeld, *MICROECONOMICS* 29 (1992).

²¹³ See *Pricing Flexibility Order*, 14 FCC Rcd at 14267-69, paras. 84-86.

parties provide disaggregated customer class data, regardless of how the commenter chooses to identify the relevant customer class(es) (e.g., the occupancy of buildings, the distribution of revenues either by building or enterprises).

(iv) **Supply Responsiveness**

97. Parties may seek to demonstrate that the market for a particular special access service is not competitive by showing that, for each product market, competitors do not have enough readily-available supply capacity to constrain the price cap LEC's market behavior. Supply responsiveness measures the ability of carriers, other than the price cap LEC, to supply enough capacity to respond to demand migrating from the price cap LEC's network in the event of a LEC price increase for its special access services.²¹⁴ Supply elasticities of a LEC's competitors may be important in assessing the level of competition for an incumbent's special access services after Phase II pricing flexibility is granted.

98. We seek comment on whether the triggers, adopted in 1999, remain reasonable when assessed against marketplace data since the granting and exercise of Phase II pricing flexibility. In the *Pricing Flexibility Order*, the Commission predicted a relationship between price cap LEC special access rates and supply responsiveness, stating that "[i]f an incumbent LEC charges an unreasonably high rate for access to an area that lacks a competitive alternative, that rate will induce competitive entry, and that entry will in turn drive rates down."²¹⁵ This assessment directly addresses the issue of sustainability. The Commission reasoned that substantial rate increases would not be sustainable because they would attract entry, increase competition, and ultimately result in lower rates.²¹⁶

99. We invite parties to provide detailed analyses of supply responsiveness,²¹⁷ including providing the relevant data and information that would be necessary to determine whether a price cap LEC's competitors are supply-responsive.²¹⁸ Parties providing this data should demonstrate the presence or lack of entry and/or increased competitive supply so that we may assess whether it is reasonable to continue to rely on our prior conclusions. We ask commenters to provide evidence showing whether there is a statistically significant relationship between higher special access rates and high levels of competitive LEC entry. Parties should quantify the purported relationship between rates and entry. For example, one way to quantify this relationship is to demonstrate a statistically significant relationship between increased competitive LEC entry and investment and the relative levels of special access rates and/or special access profit margins in MSAs where Phase II pricing flexibility has been granted. Also, we are particularly interested in data that would show whether the LEC responded to the competitive

²¹⁴ See Pindyck & Rubinfeld at 32; see also DOJ Merger Guidelines §§ 1.0, 1.3, 3 (the guidelines refer to these factors as supply substitution factors, *i.e.*, possible production responses).

²¹⁵ *Pricing Flexibility Order*, 14 FCC Rcd at 14297-98, para. 144.

²¹⁶ *Id.*

²¹⁷ Supply responsiveness is typically measured using elasticity of supply, a concept parallel to that used for demand elasticity. See Pindyck & Rubinfeld at 32. Supply elasticity measures the percentage change in the quantity supplied that results from a one percent change in the price of a product. High supply elasticity indicates that entry is relatively easy and that any attempt by an incumbent to raise prices will result in new entry. Conversely, low supply elasticity is indicative of market power.

²¹⁸ The incumbent LEC's elasticity of demand is affected by the new entrant's elasticity of supply. It may be possible to show that the incumbent LEC's demand becomes more responsive to changes in price as new entrants' supply becomes more elastic and their market share increases. Such results would indicate that, as new entrants become more capable of supplying special access services to more customers, an increase in special access prices by the incumbent LEC results in a larger decrease in the quantity of special access services purchased from the incumbent LEC and an increase in the amount supplied by the new entrants. See Dennis W. Carleton & Jeffrey M. Perloff, *MODERN INDUSTRIAL ORGANIZATION* 158-69, 172-74 (1993).

threat on a narrowly targeted basis (e.g., by offering new lower contract tariff rates to the customer or customer location (e.g., specific building) served by the competitor) or on a broader basis (e.g., MSA-wide).

100. We ask parties to provide detailed information about their existing supply of special access facilities, including their ability or inability to self-deploy transport facilities, and/or to gain access to third-party alternatives. In providing such information, it would be most helpful for parties to disaggregate data among, at least, special access channel terminations between customer premises and the LEC office, special access channel terminations between the IXC POP and the LEC wire center, and other special access facilities. In addition, we invite each commenter, for its company, to provide information about the supply of special access facilities at the MSA level for each MSA in which that company is present.²¹⁹ The most relevant data would be provided for the following time periods: deployment before and up to the granting of Phase II pricing flexibility, deployment from the time pricing flexibility was granted until the present, and planned future deployment. Further, we ask parties, now that Phase II pricing flexibility has been granted in many MSAs, to demonstrate the strength of any correlation between collocation and the provision of competitive transport facilities.²²⁰

101. We encourage competitive LECs and other parties that have deployed their own special access transport facilities to provide their actual deployment cost information instead of relying on theoretical, estimated, or modeled costs of price cap LEC special access transport facilities. To the extent that parties compare their costs to the costs of price cap LEC transport facilities, these comparisons should be made across facilities that are as similar as possible. We note that some deployment costs are location specific.

102. Finally, we note that, in certain industries, a short-term supply response may be ameliorated by other long-term supply responsiveness factors. For example, in an industry where assets can be deployed only in large increments, fixed costs are high, and there are substantial transaction costs to adding supply, we expect lags between changes in prices and a supply response.²²¹ We therefore ask parties to demonstrate that supply responsiveness trends are stable by providing evidence of long-term trends.

(v) Market Share

103. A high market share does not necessarily confer market power, but it is generally a condition precedent to a finding of market power.²²² Although the Commission did not rely on a market share analysis in the *Pricing Flexibility Order*,²²³ we now invite parties to provide data and analysis of price cap LECs' market shares for special access services, by MSA where Phase II pricing flexibility has been granted, before and after that pricing flexibility was implemented. We invite parties to supply market share data and analysis based on revenues and/or volumes on an annualized basis. If parties

²¹⁹ To the extent that a party contends that the relevant geographic market is something other than the MSA, that party should also provide information about the supply of special access facilities at the level of that geographic market (for each market).

²²⁰ *Pricing Flexibility Order*, 14 FCC Rcd at 14266-67, para. 82 (For example, in the *Pricing Flexibility Order*, the Commission recognized that the "correlation between operational collocation arrangements and competitive transport facilities is somewhat attenuated, . . . [and therefore] require[d] incumbent LECs to show that at least one competitor relies on transport facilities provided by a transport provider other than the incumbent in each wire center . . . [with] an operational collocation arrangement.").

²²¹ See Jean-Jacques Laffont & Jean Tirole, COMPETITION IN TELECOMMUNICATIONS 16-17 (2001).

²²² See DOJ Merger Guidelines § 1.11.

²²³ See *Pricing Flexibility Order*, 14 FCC Rcd at 14271-72, paras. 90-91.

choose one measure of market share over others, they should identify their proposed measure with specificity and provide a thorough justification of their choice of measurement as compared to others. We note that there are many ways of defining market share, such as volume of traffic, revenues, or network capacity. We ask parties to be specific in defining both the numerator and the denominator in the ratio that determines market share.²²⁴ For example, while parties should identify the size of the actual and potential market, they should not assume, without providing supporting evidence, that every building in an MSA is a potential customer for special access services. We also ask parties to disaggregate, as much as possible, any market share data provided by the special access product market (*e.g.*, special access channel terminations between the LEC end office and customer premises), and by customer classes. We invite parties to provide market share information at the MSA level (and any other geographic market level they deem appropriate).

104. A company that enjoys a very high market share will be constrained from raising its prices substantially above cost if the market is characterized by high supply and demand elasticities.²²⁵ In other words, an analysis of the level of competition for special access services based solely on a price cap LEC's market share at a given time may not provide sufficient evidence for us to conclude that substantial competition exists or does not exist.²²⁶ We therefore propose to consider market share in conjunction with other factors, including, but not limited to, supply and demand responsiveness, growth in demand, market shares before Phase II flexibility was implemented, and pricing trends. Market share analyses provided by commenters should take these factors into consideration.

105. In particular, market share analysis and supply responsiveness should be used jointly to assess market power. Parties should ensure that the data and analyses they provide on supply responsiveness issues are consistent with their market share analyses and data. We do not believe it necessary for parties to provide estimates of supply elasticities separately from the data and analyses they include in their comments responding to supply responsiveness issues. Instead, we intend to use the supply responsiveness data and analyses provided by parties in response to the information requested above in the Supply Responsiveness section of this NPRM.²²⁷ We expect that parties submitting this information will submit market share data and analyses that can be used in conjunction with supply responsiveness data and analyses.

106. Finally, because market share analysis is primarily concerned with ascertaining the level of competition in the wholesale special access service market, where price cap LECs provide these services to intermediate customers (*e.g.*, IXCs, CMRS providers) that ultimately supply the retail market, we invite parties to provide wholesale market share analyses and data, excluding retail market analyses and data. If parties would like to include market share analysis and data for the special access retail market, they may do so, as well. Further, we ask that parties identify whether and, if so, how UNEs are included in their analysis.

²²⁴ We require parties to be consistent between the numerator and denominator to address, in part, the problems the Commission identified with the record submitted by parties in the pricing flexibility proceeding. *See id.*, 14 FCC Rcd at 14271-72, paras. 90-91.

²²⁵ *Access Charge NPRM, Order, and NOI*, 11 FCC Rcd at 21424, para. 158. The “‘small but significant and non-transitory’ increase in price” standard is based on the assumption that supply and demand elasticities can constrain monopoly pricing. *See* DOJ Merger Guidelines § 1.11.

²²⁶ *See* DOJ Merger Guidelines § 1.11 (market share is one of many measures used to evaluate market power).

²²⁷ *See supra* section III.B.1.b(iv).

(vi) Barriers to Entry

107. An entry barrier may be defined as a cost of production that must be borne by competitors entering a market that is not borne by an incumbent already operating in the market.²²⁸ Cost advantages derived solely from the efficiency of the incumbent are not considered a barrier to entry.²²⁹ Markets where a price cap LEC owns or has access to important assets or resources that are not accessible to the potential entrant bestows an absolute advantage on the incumbent.²³⁰

108. The ease with which competitors can enter the special access market influences the level of competition in that market.²³¹ For example, a LEC might have a market share of over 50 percent but no market power if there are no significant barriers impeding entry into that market.²³² In such a situation, the threat that an increase in price could eventually attract new entrants might be real enough to discourage the price cap LEC from increasing its price. Similarly, high rates of return may attract competitors to that market if entry barriers are relatively low.

109. In the *Pricing Flexibility Order*, the Commission predicted that substantial “irreversible, or ‘sunk’ investment in facilities used to provide competitive services,” would be sufficient to constrain the LECs’ pricing behavior.²³³ Specifically, the Commission determined that collocation “usually represents a financial investment by a competitor to establish facilities within a wire center. . . . [T]he investment in transmission facilities associated with collocation arrangements is largely specific to a location; the competitive LEC’s facilities cannot, for the most part, easily be removed and used elsewhere if entry does not succeed.”²³⁴ Because these investments were location specific, the entrant incurred sunk costs,²³⁵ making it less likely that the incumbent could successfully use exclusionary strategies to drive the entrant from the market.²³⁶

110. Parties contend that the Commission’s economic reasoning is incomplete. They claim that market entry by some carriers does not fully ameliorate the effect of sunk costs as a continuing and substantial barrier to entry.²³⁷ We seek comment on whether our assessment in the *Pricing Flexibility*

²²⁸ See Spulber, *supra* note 186, at 40 (citing George J. Stigler, *THE ORGANIZATION OF INDUSTRY* 67 (1968)).

²²⁹ See *id.*

²³⁰ See *id.*

²³¹ See *id.*

²³² See Herbert Hovenkamp, *Federal Antitrust Policy – The Law of Competition and Its Practice* § 3.7d (1999).

²³³ *Pricing Flexibility Order*, 14 FCC Rcd at 14263-64, para. 79.

²³⁴ *Id.*, 14 FCC Rcd at 14265-66, para. 81.

²³⁵ Sunk costs refer to the investments that have to be made to enable production of a good or service. These costs are incurred even before a single unit of good or service is produced. An example of sunk costs can be found where the cable network has to be put in place – at a high cost – before any voice or data transmission can be made.

²³⁶ *Pricing Flexibility Order*, 14 FCC Rcd at 14264, para. 80 (“An incumbent monopolist will engage in exclusionary pricing behavior only if it believes that it will succeed in driving rivals from the market or deterring their entry altogether. . . . Once multiple rivals have entered the market and cannot be driven out, rules to prevent exclusionary pricing behavior are no longer necessary. Investment in facilities, particularly those that cannot be used for another purpose, is an important indicator of such irreversible entry. . . . [T]he presence of facilities-based competition with significant sunk investment makes exclusionary pricing behavior costly and highly unlikely to succeed.”).

²³⁷ See, e.g., Letter from Brian R. Moir, counsel for the Special Access Reform Coalition, to Marlene H. Dortch, Sec’y, Federal Communications Commission, Attach. Phoenix Center Policy Paper Number 18 (George S. Ford & Lawrence J. Spiwak, *Set It and Forget It? Market Power and the Consequences of Premature Deregulation in*

(continued....)

Order of the relationship between entry barriers and irreversible, sunk investment by competitive carriers remains sufficiently robust. We also seek comment on whether this assessment has been validated by actual marketplace developments since the *Pricing Flexibility Order* was adopted in 1999.

111. Finally, we seek comment on the effect that numerous competitors exiting the market has on our predictive judgment that collocation shows evidence of irreversible market entry. The Commission predicted that collocation equipment would remain “available and capable of providing service in competition with the incumbent, even if the incumbent succeeds in driving that competitor from the market.”²³⁸ In light of the numerous competitors that have exited the market (in whole or in part) since 1999, we seek comment on whether their collocation facilities (space and equipment) continue to be used by other competitive LECs or are available for use by competitive LECs without their first having to incur significant additional sunk costs. We note that price cap LECs retain data on which carriers are collocated in their offices (and on the equipment located in the collocation spaces), and believe such information is particularly relevant here. We, therefore, invite these LECs to provide data (disaggregated on an MSA basis) that identifies whether and how the collocation spaces and equipment of carriers that have exited the market are used by, or available to, other competitive carriers. We seek comment on what changes, if any, we should make to our pricing flexibility rules if the data show that collocation has not proven to be as accurate a proxy for irreversible competitive market entry as we expected.

(vii) Other Factors

112. We invite interested parties to provide discussion, supply data, and present analysis of other factors in addition to those discussed above that would be helpful in evaluating the level of competition for special access services in the MSAs where Phase II pricing flexibility has been granted. The discussion and analysis of these additional factors should include considerations as to the importance of these factors in making a final determination as to the level of competition in the special access market.

2. Relationship Between Market Power and Impairment Standards

113. While the Commission was working to reform its special access price cap rules in the mid-to-late 1990s, it also was implementing section 251 of the 1996 Act, which requires incumbent LECs to offer network elements on an unbundled basis.²³⁹ In undertaking its unbundling analysis, the Commission repeatedly confronted the issue of whether to unbundle network elements or combinations of network elements comprising essentially the same facilities as those used to provide special access services.²⁴⁰ Indeed, in these proceedings some parties have advocated variations on the pricing flexibility

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Telecommunications Markets (2003)) at 18 (filed July 18, 2003); see also Jean Tirole, *INDUSTRIAL ORGANIZATION* 305-56 (1994).

²³⁸ *Pricing Flexibility Order*, 14 FCC Rcd at 14264, para. 80. The Commission further explained that “[a]nother firm can buy the facilities at a price that reflects expected future earnings and, as long as it can charge a price that covers average variable cost, will be able to compete with the incumbent LEC.” *Id.*

²³⁹ See, e.g., *Triennial Review Order*, *supra* note 210, 18 FCC Rcd at 17025, para. 70; *Implementation of The Local Competition Provisions of The Telecommunications Act of 1996*, CC Docket No. 96-98, Third Report and Order and Fourth Further Notice of Proposed Rulemaking, 15 FCC Rcd 3696, 3704, para. 14 (1999) (*UNE Remand Order*) (subsequent history omitted); *Local Competition Order*, *supra* note 211, 11 FCC Rcd at 15616-775, paras. 226-541.

²⁴⁰ For example, at one time, the Commission imposed temporary use restrictions on combinations of unbundled loops and unbundled dedicated transport (known as enhanced extended links, or EELs) to prevent the unbundling requirements from “caus[ing] a significant reduction of the incumbent LECs’ special access revenues prior to full implementation of access charge and universal service reform” due to the possibility of mass migration of special access services to cost-based UNEs. *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, CC Docket No. 96-98, Supplemental Order, 15 FCC Rcd 1760, 1761, para. 3

(continued....)

standard for determining when certain network elements should be unbundled,²⁴¹ and the D.C. Circuit, in its *USTA II* decision, recently instructed the Commission to take account of tariffed special access services when conducting its unbundling inquiry.²⁴² We note that the Commission recently modified its unbundling analysis in response to *USTA II*,²⁴³ and we seek comment on the relationship, if any, between the market power threshold that underscores the pricing flexibility rules and the impairment standard for unbundling.

3. Tariff Terms and Conditions

a. Background

114. Although traditional market power analysis focuses on whether a firm can impose a substantial and sustained price increase within, and examines the cost characteristics of, the relevant geographic and product/service market, market power can also be exercised through exclusionary conduct. Such conduct may be evidenced from the terms and conditions contained in a carrier's tariff offering.²⁴⁴

115. The Commission has long been concerned about dominant carriers offering their services on terms and conditions that weaken or harm the competitive process sufficiently to reduce consumer welfare.²⁴⁵ Notably, with specific regard to special access services, the Commission has sought to exercise great care to prevent exclusionary conduct while transitioning the market from monopoly to competition.²⁴⁶ For example, the Commission permitted price cap LECs to offer volume and term discounts for special access services without any competitive showing, but it found that some large discounts might be anticompetitive or raise questions of discrimination.²⁴⁷ Moreover, it has prohibited

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(1999) (quoting *UNE Remand Order*, 15 FCC at 3913, para. 489). More recently, however, the Commission adopted new EELs eligibility criteria that were not based on the preservation of special access revenues. *Triennial Review Order*, 18 FCC Rcd at 17350-61, paras. 590-611.

²⁴¹ *Triennial Review Order*, 18 FCC Rcd at 17182-83, 17225-26, paras. 341, 397.

²⁴² *United States Telecom Ass'n v. FCC*, 359 F.3d 554, 577 (D.C. Cir. 2004) (*USTA II*), *pets. for cert. filed*, Nos. 04-12, 04-15, 04-18 (June 30, 2004).

²⁴³ *See FCC Adopts New Rules for Network Unbundling Obligations of Incumbent Local Phone Carriers*, FCC News (Dec. 15, 2004).

²⁴⁴ *See, e.g., AT&T v. Central Office Tel., Inc.*, 524 U.S. 214, 223 (1998) ("Rates, however, do not exist in isolation. They only have meaning when one knows the services to which they are attached."), *rehearing denied*, 524 U.S. 972.

²⁴⁵ *See, e.g., Expanded Interconnection with Local Telephone Company Facilities*, CC Docket Nos. 91-141, 92-222, Report and Order and Notice of Proposed Rulemaking, 7 FCC Rcd 7369, 7463, para. 201 (1992) (*Expanded Interconnection Order*), *modified by* 7 FCC Rcd 7936 (1992), *rev'd, in part, on other grounds, Bell Atlantic Tel. Cos. v. FCC*, 24 F.3d 1441 (D.C. Cir. 1994), *reinstated in pertinent part, Expanded Interconnection with Local Telephone Company Facilities*, CC Docket No. 91-141, Memorandum Opinion and Order, 9 FCC Rcd 5154, 5156, 5200-01, paras. 4, 168-71; *AT&T Communications Tariff F.C.C. No. 15, Competitive Pricing Plan No. 2, Resort Condominiums International*, CC Docket No. 90-11, Memorandum Opinion and Order 5648, 5649-50, paras. 12-22.

²⁴⁶ *See Expanded Interconnection Order*, 7 FCC Rcd at 7447-70, paras. 164-215.

²⁴⁷ *See id.*, 7 FCC Rcd at 7463, para. 200.

price cap LECs from incorporating growth discounts into their tariffs.²⁴⁸ The Commission has also limited the termination liabilities that carriers may include in their tariffs.²⁴⁹

116. In the *AT&T Petition for Rulemaking* and responses thereto, parties have complained that the terms and conditions for special access services in the tariff offerings of price cap LECs represent exclusionary conduct designed to deter market entry or to induce market exit.²⁵⁰ They argue that the price cap LECs, as dominant firms, can and have adopted pricing structures through tariff terms and conditions that negate the price breaks a competitor can offer a customer for a particular service because the customer would then lose its discounts from the price cap LEC on other services or in other markets.²⁵¹ They contend that dominant firms are likely to engage in this form of exclusionary conduct because, unlike classic exclusionary pricing, this conduct does not require the firm to set any price below cost.²⁵²

117. The BOCs respond that allegations of strategic anticompetitive pricing represent mere theoretical arguments and that they have not engaged in exclusionary conduct.²⁵³ They point out that special deals to attract or retain customers may injure individual competitors but result in a net increase in overall consumer welfare.²⁵⁴ They claim, moreover, that a general restriction on any discriminatory conduct would restrict competitive behavior and harm consumers by denying them the direct benefit of the tariff terms (including any volume and term price reductions) and by reducing the vigor of competition.²⁵⁵ The BOCs also contend that the pricing flexibility triggers, which serve as a proxy for irreversible market entry, ensure that any anticompetitive strategy to frustrate entry through the use of pricing flexibility tariffs or contract tariffs is too late to be effective.²⁵⁶

118. Further, the BOCs claim that precluding the use of volume and term discounts would place them at a competitive disadvantage.²⁵⁷ Long-term contracts assure recovery of direct facility costs and allow amortization of up-front sunk costs over the life of the transaction. The BOCs argue that customers willingly agree to volume and term commitments to obtain discounts and that every carrier makes available such offerings in all forms of their tariffs.²⁵⁸ Finally, they contend that the complaining parties have extensive networks of their own and can simply elect to self-provision any service they choose not to purchase from a BOC.²⁵⁹

²⁴⁸ See *Transport Rate Structure and Pricing*, CC Docket No. 91-213, Fourth Memorandum Opinion and Order on Reconsideration, 10 FCC Rcd 12979, 12985, at para. 17 (1995).

²⁴⁹ See *Expanded Interconnection Order*, 7 FCC Rcd at 7464, para. 202.

²⁵⁰ These complaints relate to the terms and conditions contained in the BOCs' price cap tariffs, their contract tariffs (offered after receiving and exercising Phase I or Phase II pricing flexibility), and their Phase II pricing flexibility tariffs. See, e.g., *AT&T Petition for Rulemaking* at 18-23; Arch Wireless Comments at 4; WorldCom Comments at 11-12, Pelcovits Decl. at 11-15; XO Comments at 5-7. Although our discussion of contract terms and conditions occurs within the pricing flexibility section of the NPRM, we invite parties to comment on tariff terms and conditions for any of these forms of tariffs.

²⁵¹ WorldCom Reply, Pelcovits Decl. at 8, 11.

²⁵² *Id.* at 5.

²⁵³ Kahn/Taylor Decl., *supra* note 77, at 29.

²⁵⁴ *Id.* at 30.

²⁵⁵ *Id.*

²⁵⁶ *Id.* at 31.

²⁵⁷ *Id.*

²⁵⁸ *Id.* at 32.

²⁵⁹ *Id.* at 33.

b. Discussion

119. There are several reasons that a firm might bundle product offerings.²⁶⁰ We are concerned here with whether a firm bundles the purchase of one product with the purchase of a product the customer might otherwise not have made. A provider dominant in one product may seek to influence the purchase of other products by imposing terms and conditions that bundle the products together. As with the market power type analysis described above, in evaluating the terms and conditions associated with a price cap LEC tariff offering, parties should identify the special access product and geographic markets.²⁶¹

120. As a first approximation, special access service involves facilities dedicated to connecting two locations. We seek comment on whether this connection is a single product or whether it represents several products. In the *Pricing Flexibility Order*, the Commission identified three categories of product markets for special access services: (1) special access channel terminations between a price cap incumbent LEC's end office and customer premises, (2) special access channel terminations between an IXC POP and a LEC service wire center and channel terminations and (3) other special access facilities.²⁶² As explained *supra* in section III.B.1.b(i), we seek comment on whether these continue to be the relevant product markets. The Commission also identified the MSA as the relevant geographic market. As explained *supra* in section III.B.1.b(ii), we seek comment on whether this remains the logical geographical market.

121. In conjunction with these product and geographic market analyses for special access services, we seek comment on the reasonableness of various levels of aggregation that a carrier may require of a customer to qualify for a discount.²⁶³ For example, are there cost justifications for bundling discounts with aggregations of services (*e.g.*, DS-1, DS-3, OCn) and/or geographic regions (*e.g.*, routes, wire centers, zones, LATAs, LEC footprints)? Is it reasonable for LECs to require that customers aggregate purchases across equivalent transport and special access products (*e.g.*, channel terminations and entrance facilities)? We also seek comment and data on whether, where there are discounts based on aggregations of products, price cap LECs offer equivalent non-bundled, product-by-product discounts.

122. Where a volume commitment is a condition precedent to obtaining a discount, we seek comment on whether it is reasonable to condition the discount to the (individual) customer's previous purchase level. We invite parties to comment on whether the manner of specifying volume levels affects the quality of competition. We also seek comment on how the discounts offered in price cap LEC tariffs vary with the volume of service purchased. Is there a trade-off between the amount of aggregation allowed and the restrictiveness of the discount terms that we allow? Finally, parties should comment on whether they believe such conditioning of discounts on prior volumes and future volume commitments violates our prohibition on growth discounts.²⁶⁴

123. Where discounts are based on the length of the term commitment, we seek comment on the relationship between up-front, non-recurring charges and termination penalties. Prior to the advent of competition, the trade-off between an up-front charge and amortization over the lease period was the cost

²⁶⁰ See Robert B. Wilson, *NONLINEAR PRICING* 7-8 (1993) (discussing appropriate and inappropriate reasons to bundle product offerings).

²⁶¹ See *supra* sections III.B.1.b(i)-III.B.1.b(ii).

²⁶² *Pricing Flexibility Order*, 14 FCC Rcd at 14234-35, 14273-74, 14278-81, 14299-300, paras. 24-25, 93, 100-07, 148-50.

²⁶³ For instance, Ameritech's tariff appears to require volume and term discounts be based on each customer's previous total regional purchase of service. Ameritech Tariff F.C.C. No. 2 §§ 19.3(B)-(D).

²⁶⁴ See *Pricing Flexibility Order*, 14 FCC Rcd at 14294, paras. 134-35.

of money. With competition, non-recurring charges and termination penalties raise issues concerning barriers to entry, risk bearing, and retail versus wholesale churn. We seek comment on whether we should allow or require up-front, non-recurring charges to recover the costs associated with initiating service for a specific customer. Should we require amortization over the life of the facility of the cost of activities that benefit all customers using the facility?

124. Additionally, we seek comment on whether it is reasonable for a price cap LEC to bundle a tariff discount with the condition that the customer terminates service with a competitor. Is such bundling for the same service on the same route reasonable?

125. Finally, we ask parties to comment on whether it is reasonable for a price cap LEC to bundle a tariff discount with restrictions on the use or reuse of a facility.

4. Relationship Between New Pricing Flexibility Rules and New Special Access Price Cap Rules

126. If we modify the pricing flexibility rules, we seek comment on whether and how to adjust the price cap rules to incorporate the affects of changes in the pricing flexibility rules. In the event that a price cap LEC currently has pricing flexibility for services for which it will not have flexibility under any new rules we adopt, we tentatively conclude that rates for these services should be regulated no differently from rates for services for which a LEC never had pricing flexibility and for which it would have none under any new criteria. We may, for example, adopt a single price cap special access basket that includes separate categories for special access DS1 channel terminations extending between a price cap LEC end office and a customer premises, for DS1 channel termination services extending between a price cap LEC serving wire center and an IXC POP, and for DS1 interoffice facilities. If, in this example, a LEC either never had pricing flexibility for DS1 special access services, or currently has pricing flexibility but will no longer have it for these services under any new criteria, it would have to establish separate rates in a tariff and categories within the basket for each of the three service categories. Going forward, under the new price cap rules, the rate levels for the DS1 channel termination and interoffice facility services would be subject to the upper SBI limit for each category. These rate levels also would be constrained, as would those for any other special access service subject to price caps, because they are reflected in the API for the special access services basket that, in turn, must not exceed the PCI for the basket. We tentatively conclude that services subject to a new price cap plan going forward should be treated the same regardless of whether they never had or currently have pricing flexibility because, under the new criteria, there presumably is no distinction between the two services. We seek comment on this tentative conclusion. We also invite comment on other options under a new price cap plan for regulating rates for services that currently have pricing flexibility, but would have none under any new rules we might adopt.

127. We tentatively conclude that we should use the same approach to establish initial rates under a new price cap plan for services for which a LEC currently has pricing flexibility, but will have none going forward under any new criteria we adopt in this proceeding, and for services for which a LEC never had pricing flexibility and for which it would have none under any new pricing flexibility criteria. For example, if we find that initial rates should be based on a forward-looking cost study, rates for both of these categories of services would be set based on a forward-looking cost study, even though previously they were regulated differently. Again, there presumably is no distinction between the two services under any new pricing flexibility criteria that we adopt. There is therefore no obvious reason to establish initial rates for these services using different methods. We seek comment on this tentative conclusion. We also invite comment on other options under a new price cap plan for setting initial rates for services that currently have pricing flexibility, but would have none under any new criteria we adopt.

C. Interim Relief

128. AT&T has requested that, while the requested rulemaking is pending, the Commission: “(1) immediately reduce all special access charges for services subject to Phase II pricing flexibility to the rates that would produce an 11.25% rate of return[,] and (2) impose a moratorium on consideration of further pricing flexibility applications pending completion of the rulemaking.”²⁶⁵ We reject AT&T’s requests at this time.²⁶⁶ As discussed throughout this NPRM, we are fulfilling our ongoing commitment to re-examine periodically rules based on predictive judgments and to evaluate whether those judgments are, in fact, substantiated by marketplace developments.²⁶⁷ As described above, evaluating the reasonableness of the Commission’s predictions is a complex undertaking and we do not yet have sufficient data in the record to enable us to foresee the likely outcome of this analysis.

129. We do not find the evidence submitted by AT&T in its petition sufficient to justify the requested relief at this time. In particular, AT&T did not and could not, based on the paucity of data, establish the relationship between high rates of return and Phase II pricing flexibility. The most recent data presented in the *AT&T Petition for Rulemaking* dated from 2001.²⁶⁸ The BOCs only implemented Phase II pricing flexibility in late 2000 and 2001.²⁶⁹ One year’s data are insufficient to support conclusions about the relationship between pricing flexibility and high rates of return. Even if the Commission had enough data, moreover, we question AT&T’s central reliance on accounting rate of return data to draw conclusions about market power. High or increasing rates of return calculated using regulatory cost assignments for special access services do not in themselves indicate the exercise of monopoly power.²⁷⁰

130. Furthermore, even assuming that AT&T had established a strong likelihood that we would reverse or modify the findings of the *Pricing Flexibility Order*, the request for a re-initialization of certain special access rates to levels that would produce an 11.25 percent rate of return has not been justified. The request goes well beyond restoring the rate levels that would have been in place had the Commission never adopted the pricing flexibility rules that have been challenged. Given the complexities of setting reasonable special access rates and their interrelationship with other price cap rates, this requested interim relief is not warranted by the record now before us. Specifically, the record does not support a finding that every special access rate established pursuant to a grant of Phase II pricing flexibility violates section 201 of the Communications Act.²⁷¹ In addition, we find the record inadequate for prescribing new special access rates pursuant to section 205 of the Communications Act.²⁷² We note, however, that further development of evidence in the record may justify future interim relief if we conclude it is necessary to avoid market disruption as we move towards broad reforms.²⁷³

²⁶⁵ *AT&T Petition for Rulemaking* at 39.

²⁶⁶ Because we reject AT&T’s first two requests, we do not need to reach its third request, that the requested relief not trigger any termination liabilities in the carrier OPP Plans. *Id.* at 40.

²⁶⁷ *Pricing Flexibility Order*, 14 FCC Rcd at 14261-81, 14288-302, paras. 77-107, 121-56.

²⁶⁸ *AT&T Petition for Rulemaking* at 7-16.

²⁶⁹ *BellSouth Petition for Pricing Flexibility for Special Access and Dedicated Transport Services*, CCB/CPD File No. 00-20, Memorandum Opinion and Order, 15 FCC Rcd 24588, para. 1 (CCB 2000) (granting the first filed pricing flexibility application on December 14, 2000).

²⁷⁰ See Fisher & McGowan, *supra* note 167, 73 AMERICAN ECON. REV. at 83.

²⁷¹ 47 U.S.C. § 201.

²⁷² 47 U.S.C. § 205.

²⁷³ See *Competitive Telecommunications Ass’n v. FCC*, 309 F.3d 8, 14 (D.C. Cir. 2002).

131. As a separate issue, however, we seek comment on what interim relief, if any, is necessary to ensure special access rates remain reasonable while we consider what regulatory regime will follow the CALLS plan. Given the complexities of the proceeding we initiate in this NPRM, there is a strong likelihood this proceeding will not be completed prior to July 1, 2005. This record contains substantial evidence suggesting that productivity has increased and continues to increase in the provision of special access services.²⁷⁴ 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.²⁷⁵ 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. One interim option would be to impose the last productivity factor, 5.3 percent, that was adopted by the Commission and judicially upheld.²⁷⁶ We seek comment on this and other reasonable interim alternatives.

IV. PROCEDURAL MATTERS

A. *Ex Parte* Requirements

132. This proceeding will continue to be governed by “permit-but-disclose” *ex parte* procedures that are applicable to non-restricted proceedings under 47 C.F.R. § 1.1206.²⁷⁷ Parties making oral *ex parte* presentations are reminded that memoranda summarizing the presentation must contain a summary of the substance of the presentation and not merely a listing of the subjects discussed. More than a one- or two-sentence description of the views and arguments presented generally is required.²⁷⁸ Other rules pertaining to oral and written presentations are set forth in section 1.1206(b) as well.²⁷⁹ Interested parties are to file any written *ex parte* presentations in this proceeding with the Commission’s Secretary, Marlene H. Dortch, 445 12th Street, S.W., TW-B204, Washington, D.C. 20554, and serve with one copy: Pricing Policy Division, Wireline Competition Bureau, 445 12th Street, S.W., Room 5-A452, Washington, D.C. 20554, Attn: Jeremy D. Marcus. Parties shall also serve with one copy: Best Copy and Printing, Inc., Portals II, 445 12th Street, S.W., Room, CY-B402, Washington, D.C., 20554, telephone (202) 488-5300, facsimile (202) 488-5563, e-mail fcc@bcpiweb.com, or via its website <http://www.bcpiweb.com>.

B. Initial Paperwork Reduction Act Analysis

133. This document does not contain proposed information collection(s) subject to the Paperwork Reduction Act of 1995 (PRA), Public Law 104-13. In addition, therefore, it does not contain any new or modified “information collection burden for small business concerns with fewer than 25 employees,” pursuant to the Small Business Paperwork Relief Act of 2002, Public Law 107-198, *see* 44 U.S.C. § 3506(c)(4).

²⁷⁴ *See supra* section III.A.1.

²⁷⁵ *See* 47 C.F.R. § 61.45(b)(1)(iv); *CALLS Order*, 15 FCC Rcd at 13025, paras. 149, 151.

²⁷⁶ *1995 Price Cap Review Order*, 10 FCC Rcd at 9050, para. 198, *aff’d Bell Atlantic Tel. Cos. v. FCC*, 79 F.3d 1195, 1202-05 (D.C. Cir. 1996).

²⁷⁷ *See* 47 C.F.R. § 1.1206.

²⁷⁸ *See* 47 C.F.R. § 1.1206(b)(2).

²⁷⁹ *See id.*

C. Initial Regulatory Flexibility Analysis

134. As required by the Regulatory Flexibility Act of 1980, as amended (RFA),²⁸⁰ the Commission has prepared this present Initial Regulatory Flexibility Analysis (IRFA) of the possible significant economic impact on a substantial number of small entities by the policies and rules proposed in this NPRM. Written public comments are requested on this IRFA. Comments must be identified as responses to the IRFA and must be filed by the deadlines for comments on the NPRM provided in paragraph 62 of the item. The Commission will send a copy of the NPRM, including this IRFA, to the Chief Counsel for Advocacy of the Small Business Administration (SBA).²⁸¹ In addition, the NPRM and IRFA (or summaries thereof) will be published in the Federal Register.²⁸²

1. Need for, and Objectives of, the Proposed Rules

135. In this NPRM, the Commission explores the appropriate regulatory regime to establish for price cap LEC interstate special access services after June 30, 2005.²⁸³ The Commission tentatively concludes that a price cap regime should continue to apply and seeks comment on this tentative conclusion.²⁸⁴ The Commission also seeks comment on the appropriate rate structure and levels under any such price cap regime, including seeking comment on: a productivity factor,²⁸⁵ a growth factor,²⁸⁶ earnings sharing,²⁸⁷ a low-end adjustment,²⁸⁸ rate baskets and bands,²⁸⁹ and the initial rates.²⁹⁰ As part of our examination, we also seek comment on whether to maintain, modify, or repeal the pricing flexibility rules.²⁹¹ Finally, we deny AT&T's requests that we impose a temporary moratorium on pricing flexibility applications and that we re-initialize interstate special access rates presently subject to pricing flexibility by applying an 11.25 percent rate of return.²⁹²

2. Legal Basis

136. This rulemaking action is supported by sections 1, 2, 4(i), 4(j), 201-205, and 303 of the Communications Act of 1934, as amended.²⁹³

²⁸⁰ See 5 U.S.C. § 603. The RFA, *see* 5 U.S.C. §§ 601-12, has been amended by the Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA), Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996).

²⁸¹ See 5 U.S.C. § 603(a).

²⁸² See *id.*

²⁸³ See *supra* sections I, III.A-III.B.

²⁸⁴ See *supra* section III.A.

²⁸⁵ See *supra* section III.A.2.a.

²⁸⁶ See *supra* section III.A.2.b.

²⁸⁷ See *supra* section III.A.2.c.

²⁸⁸ See *supra* section III.A.2.d.

²⁸⁹ See *supra* section III.A.3.

²⁹⁰ See *supra* section III.A.4.

²⁹¹ See *supra* section III.B.

²⁹² See *supra* section III.C.

²⁹³ 47 U.S.C. §§ 151, 152, 154(i), 154(j), 201-205, and 303.

3. Description and Estimate of the Number of Small Entities to Which the Notice will Apply

137. The RFA directs agencies to provide a description of, and, where feasible, an estimate of the number of small entities that may be affected by the proposed rules, if adopted.²⁹⁴ The RFA generally defines the term “small entity” as having the same meaning as the terms “small business,” “small organization,” and “small governmental jurisdiction.”²⁹⁵ In addition, the term “small business” has the same meaning as the term “small business concern” under the Small Business Act.²⁹⁶ A “small business concern” is one which: (1) is independently owned and operated; (2) is not dominant in its field of operation; and (3) satisfies any additional criteria established by the SBA.²⁹⁷

138. In this section, we further describe and estimate the number of small entity licensees and regulatees that may also be directly affected by rules adopted in this order. The most reliable source of information regarding the total numbers of certain common carrier and related providers nationwide, as well as the number of commercial wireless entities, appears to be the data that the Commission publishes in its *Trends in Telephone Service* report.²⁹⁸ The SBA has developed small business size standards for wireline and wireless small businesses within the three commercial census categories of Wired Telecommunications Carriers,²⁹⁹ Paging,³⁰⁰ and Cellular and Other Wireless Telecommunications.³⁰¹ Under these categories, a business is small if it has 1,500 or fewer employees. Below, using the above size standards and others, we discuss the total estimated numbers of small businesses that might be affected by our actions.

139. We have included small incumbent LECs in this present RFA analysis. As noted above, a “small business” under the RFA is one that, *inter alia*, meets the pertinent small business size standard (e.g., a wired telecommunications carrier having 1,500 or fewer employees), and “is not dominant in its field of operation.”³⁰² The SBA’s Office of Advocacy contends that, for RFA purposes, small incumbent LECs are not dominant in their field of operation because any such dominance is not “national” in scope.³⁰³ We have therefore included small incumbent LECs in this RFA analysis, although we

²⁹⁴ 5 U.S.C. § 603(b)(3).

²⁹⁵ 5 U.S.C. § 601(6).

²⁹⁶ 5 U.S.C. § 601(3) (incorporating by reference the definition of “small business concern” in the Small Business Act, 5 U.S.C. § 632). Pursuant to 5 U.S.C. § 601(3), the statutory definition of a small business applies “unless an agency, after consultation with the Office of Advocacy of the Small Business Administration and after opportunity for public comment, establishes one or more definitions of such term which are appropriate to the activities of the agency and publishes such definition(s) in the Federal Register.”

²⁹⁷ 15 U.S.C. § 632.

²⁹⁸ FCC, Wireline Competition Bureau, Industry Analysis and Technology Division, *Trends in Telephone Service*, Table 5.3 (August 2003) (*Trends in Telephone Service*).

²⁹⁹ 13 C.F.R. § 121.201, North American Industry Classification System (NAICS) code 517110 (changed from 513310 in October 2002).

³⁰⁰ *Id.* § 121.201, NAICS code 517211 (changed from 513321 in October 2002).

³⁰¹ *Id.* § 121.201, NAICS code 517212 (changed from 513322 in October 2002).

³⁰² 5 U.S.C. § 601(3).

³⁰³ Letter from Jere W. Glover, Chief Counsel for Advocacy, SBA, to William E. Kennard, Chairman, FCC (May 27, 1999). The Small Business Act contains a definition of “small business concern,” which the RFA incorporates into its own definition of “small business.” See 15 U.S.C. § 632(a); 5 U.S.C. § 601(3). SBA regulations interpret “small business concern” to include the concept of dominance on a national basis. 13 C.F.R. § 121.102(b).

emphasize that this RFA action has no effect on Commission analyses and determinations in other, non-RFA contexts.

140. *Wired Telecommunications Carriers.* The SBA has developed a small business size standard for Wired Telecommunications Carriers, which consists of all such companies having 1,500 or fewer employees.³⁰⁴ According to Census Bureau data for 1997, there were 2,225 firms in this category, total, that operated for the entire year.³⁰⁵ Of this total, 2,201 firms had employment of 999 or fewer employees, and an additional 24 firms had employment of 1,000 employees or more.³⁰⁶ Thus, under this size standard, the majority of firms can be considered small.

141. *Incumbent Local Exchange Carriers (LECs).* Neither the Commission nor the SBA has developed a size standard for small businesses specifically applicable to incumbent local exchange services. The closest applicable size standard under SBA rules is for Wired Telecommunications Carriers. Under that size standard, such a business is small if it has 1,500 or fewer employees.³⁰⁷ According to Commission data,³⁰⁸ 1,337 carriers reported that they were engaged in the provision of local exchange services. Of these 1,337 carriers, an estimated 1,032 have 1,500 or fewer employees and 305 have more than 1,500 employees. Consequently, the Commission estimates that most providers of incumbent local exchange service are small businesses that may be affected by the rules and policies adopted herein.

142. *Competitive Local Exchange Carriers (CLECs), Competitive Access Providers (CAPs), and "Other Local Exchange Carriers."* Neither the Commission nor the SBA has developed a size standard for small businesses specifically applicable to providers of competitive exchange services or to competitive access providers or to "Other Local Exchange Carriers," all of which are discrete categories under which TRS data are collected. The closest applicable size standard under SBA rules is for Wired Telecommunications Carriers. Under that size standard, such a business is small if it has 1,500 or fewer employees.³⁰⁹ According to Commission data,³¹⁰ 609 companies reported that they were engaged in the provision of either competitive access provider services or competitive local exchange carrier services. Of these 609 companies, an estimated 458 have 1,500 or fewer employees and 151 have more than 1,500 employees.³¹¹ In addition, 35 carriers reported that they were "Other Local Service Providers." Of the 35 "Other Local Service Providers," an estimated 34 have 1,500 or fewer employees and one has more than 1,500 employees.³¹² Consequently, the Commission estimates that most providers of competitive local exchange service, competitive access providers, and "Other Local Exchange Carriers" are small entities that may be affected by the rules and policies adopted herein.

³⁰⁴ 13 C.F.R. § 121.201, NAICS code 517110 (changed from 513310 in October 2002).

³⁰⁵ U.S. Census Bureau, 1997 Economic Census, Subject Series: Information, "Establishment and Firm Size (Including Legal Form of Organization)," Table 5, NAICS code 513310 (issued October 2000).

³⁰⁶ *Id.* The census data do not provide a more precise estimate of the number of firms that have employment of 1,500 or fewer employees; the largest category provided is "Firms with 1,000 employees or more."

³⁰⁷ 13 C.F.R. § 121.201, NAICS code 517110 (changed from 513310 in October 2002).

³⁰⁸ *Trends in Telephone Service* at Table 5.3.

³⁰⁹ 13 C.F.R. § 121.201, NAICS code 517110 (changed from 513310 in October 2002).

³¹⁰ *Trends in Telephone Service* at Table 5.3.

³¹¹ *Id.*

³¹² *Id.*

4. Description of Projected Reporting, Recordkeeping, and Other Compliance Requirements

143. The NPRM explores the appropriate post-June 30, 2005 interstate special access regime for price cap carriers.³¹³ The NPRM considers the varying options on setting rate structures and rate levels, as well as whether to maintain, modify, or repeal the pricing flexibility rules.³¹⁴ If we determine to retain without modification the pricing flexibility rules and permit the existing price cap interstate special access regime to continue unchanged, there will be no additional reporting or recordkeeping burden on price cap LECs with respect to interstate special access rate structures or rate levels. If we adopt new or modified interstate special access charge rules, including without limitation the pricing flexibility rules, such rule changes may require additional or modified recordkeeping. For example, price cap LECs may have to file amendments to certain aspects of their interstate special access tariffs.³¹⁵

5. Steps Taken To Minimize Significant Economic Impact on Small Entities, and Significant Alternatives Considered

144. The RFA requires an agency to describe any significant alternatives that it has considered in reaching its proposed approach, which may include the following four alternatives (among others): (1) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (2) the clarification, consolidation, or simplification of compliance or reporting requirements under the rule for small entities; (3) the use of performance, rather than design, standards; and (4) an exemption from coverage of the rule, or any part thereof, for small entities.³¹⁶

145. The overall objective of this proceeding is to determine the appropriate interstate access charge regime for price cap LECs. As part of our examination, we seek comment on the appropriate price cap interstate special access rate structures and levels, including seeking comment on: a productivity factor,³¹⁷ a growth factor,³¹⁸ earnings sharing,³¹⁹ a low-end adjustment,³²⁰ rate baskets and bands,³²¹ and the initial rates.³²² We also seek comment on whether to maintain, modify, or repeal the pricing flexibility rules.³²³ We have invited commenters to provide economic analysis and data. We will consider any proposals made to minimize significant economic impact on small entities.

6. Federal Rules That May Duplicate, Overlap, or Conflict With the Proposed Rules

146. None.

³¹³ See *supra* sections I, III.A-III.B.

³¹⁴ See *supra* section III.A-III.B.

³¹⁵ See *supra* section III.

³¹⁶ 5 U.S.C. § 603(c)(1)–(c)(4).

³¹⁷ See *supra* section III.A.2.a.

³¹⁸ See *supra* section III.A.2.b.

³¹⁹ See *supra* section III.A.2.c.

³²⁰ See *supra* section III.A.2.d.

³²¹ See *supra* section III.A.3.

³²² See *supra* section III.A.4.

³²³ See *supra* section III.B.

D. Comment Filing Procedures

147. Pursuant to Sections 1.415 and 1.419 of the Commission's rules,³²⁴ interested parties may file comments on or before 60 days and reply comments on or before 90 days after publication of this NPRM in the Federal Register. **All pleadings must reference WC Docket No. 05-25.** Comments may be filed using the Commission's Electronic Comment Filing System (ECFS) or by filing paper copies.³²⁵ Comments filed through the ECFS can be sent as an electronic file via the Internet to <http://www.fcc.gov/cgb/ecfs>. Generally, only one copy of an electronic submission must be filed. If multiple docket or rulemaking numbers appear in the caption of this proceeding, however, commenters must transmit one electronic copy of the comments to each docket or rulemaking number referenced in the caption. In completing the transmittal screen, commenters should include their full name, U.S. Postal Service mailing address, and the applicable docket or rulemaking number. Parties may also submit an electronic comment by Internet e-mail. To get filing instructions for e-mail comments, commenters should send an e-mail to ecfs@fcc.gov, and should include the following words in the body of the message: "get form <your e-mail address>." A sample form and directions will be sent in reply. Commenters also may obtain a copy of the ASCII Electronic Transmittal Form (FORM-ET) at <http://www.fcc.gov/e-file/email.html>.

148. Parties who choose to file by paper must file an original and four copies of each filing. If more than one docket or rulemaking number appear in the caption of this proceeding, commenters must submit two additional copies for each additional docket or rulemaking number.

149. Filings can be sent by hand or messenger delivery, by commercial overnight courier, or by first-class or overnight U.S. Postal Service mail (although we continue to experience delays in receiving U.S. Postal Service mail). The Commission's contractor, Natek, Inc., will receive hand-delivered or messenger-delivered paper filings for the Commission's Secretary at 236 Massachusetts Avenue, N.E., Suite 110, Washington, D.C. 20002.

- The filing hours at this location are 8:00 a.m. to 7:00 p.m.
- All hand deliveries must be held together with rubber bands or fasteners.
- Any envelopes must be disposed of before entering the building.
- Commercial overnight mail (other than U.S. Postal Service Express Mail and Priority Mail) must be sent to 9300 East Hampton Drive, Capitol Heights, MD 20743.
- All filings must be addressed to the Commission's Secretary, Office of the Secretary, Federal Communications Commission.

150. Regardless of whether parties choose to file electronically or by paper, parties should also file one copy of any documents filed in this docket with the Commission's copy contractor, Best Copy and Printing, Inc., Portals II, 445 12th Street, S.W., Washington, DC 20554, telephone (202) 488-5300, facsimile (202) 488-5563, e-mail fcc@bcpiweb.com, or via its website at <http://www.bcpiweb.com>. In addition, one copy of each submission must be filed with the Chief, Pricing Policy Division, 445 12th Street, S.W., Washington, DC 20554. Documents filed in this proceeding will be available for public inspection during regular business hours in the Commission's Reference Information Center, 445 12th Street, S.W., Washington, DC 20554, and will be placed on the Commission's Internet site. For further information, contact Jeremy D. Marcus at (202) 418-0059.

³²⁴ 47 C.F.R. §§ 1.415, 1.419.

³²⁵ See *Electronic Filing of Documents in Rulemaking Proceedings*, 63 Fed. Reg. 24121 (1998).

151. Accessible formats (computer diskettes, large print, audio recording and Braille) are available to persons with disabilities by contacting the Consumer & Governmental Affairs Bureau, at (202) 418-0531, TTY (202) 418-7365, or at <fcc504@fcc.gov>.

V. ORDERING CLAUSES

152. Accordingly, IT IS ORDERED that, pursuant to the authority contained in section 1.407 of the Commission's rules, 47 C.F.R. § 1.407, the AT&T Corp. Petition for Rulemaking IS GRANTED to the extent specified herein and otherwise IS DENIED.

153. IT IS FURTHER ORDERED that, pursuant to the authority contained in sections 1, 2, 4(i), 4(j), 201-205, and 303 of the Communications Act of 1934, as amended, 47 U.S.C. §§ 151, 152, 154(i), 154(j), 201-205, and 303, NOTICE IS HEREBY GIVEN of the rulemaking described above and COMMENT IS SOUGHT on those issues.

154. IT IS FURTHER ORDERED that the Commission's Consumer Information Bureau, Reference Information Center, SHALL SEND a copy of this Notice of Proposed Rulemaking, including the Initial Regulatory Flexibility Analysis, to the Chief Counsel for Advocacy of the Small Business Administration.

FEDERAL COMMUNICATIONS COMMISSION

Marlene H. Dortch
Secretary