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Ann Cole
Commission Clerk
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, FL 32399-0850

Re : Undocketed CLEC Intrastate Access Charges

Dear Ms. Cole:

Enclosed for filing in the above matter are the original and seven (7) copies of a white paper prepared by QSI Consulting, Inc. on the subject of CLEC Intrastate Access Charges. This paper was discussed at the Staff workshop held on July 16, 2008.

Thank you for your assistance. Please let me know if you have any questions.

Sincerely,

Vicki Gordon Kaufman
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Cc: Adam Tietzman
David Dowds
Beth Salak
Sally Simmons

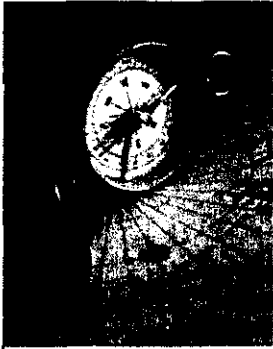
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QSI Policy Analysis

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EXCHANGE ACCESS RATES FOR COMPETITIVE LOCAL EXCHANGE CARRIERS

A Basis for Economically Rational Pricing Policies

August 2008

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The views and opinions expressed in this report are solely those of QSI Consulting, Inc., and are not intended to reflect the views of any other party.

QSI Consulting, Inc. is a consulting firm specializing in traditional and non-traditional network industries, econometric analysis, technology convergence and computer-aided modeling. QSI's consultants provide services to a wide array of clients, including multi-billion dollar telecommunications firms, small start-up companies, state legislatures and regulatory agencies.

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EXECUTIVE SUMMARY

Forcing Competitive Local Exchange Carriers (“CLECs”) to set switched access rates at levels that have no relationship to CLEC costs is bad public policy and unsound economics. This policy, called “benchmarking,” was first introduced in 2001, when the Federal Communications Commission (“FCC”) prohibited CLECs from tariffing interstate exchange access rates (often referred to as “switched access charges”) at levels *higher* than those of incumbent local exchange carriers (“ILECs.”)¹ While the FCC noted that its policies were merely transitional² and adopted mostly for fear that its complaint process would be overwhelmed,³ seven years later this transitional policy is still in place. Disturbingly, a number of parties continue to promote benchmarking and want to go so far as to extend the FCC’s transitional policy into the state regulatory arena. This paper discusses why benchmarking policy initiatives should be rejected.

First and foremost we demonstrate that the alleged “problem” of CLEC exchange access rate levels is contrived.⁴ We show that both interstate and intrastate exchange access rates of *all* LECs vary⁵ widely across the United States – *and they should*. Exchange access services are wholesale services and the standing regulatory paradigm is that rates for wholesale services should reflect *company specific circumstances and costs*. This is true not only for exchange access services offered by ILECs but also for other wholesale services, such as, wholesale loops and transport and resale products. Once this is recognized, it is clear that the CLECs’ rates are not anomalous because they happen to be different from those of AT&T, Qwest and Verizon.

In fact, as we show, CLEC exchange access rates as a whole are generally rational and in line with the rates of similarly situated ILECs. To be sure, the fact that the CLECs’ exchange access rates are often higher than AT&T’s, Verizon’s or Qwest’s rates in no way is indicative of CLEC market power – *virtually all LECs have higher exchange access rates than AT&T, Verizon and Qwest*. How could they not? The big three are enormous, vertically integrated firms with huge economies of scale and scope that dwarf the remainder of the industry. We show that any claims of CLEC market power fly in the face of the CLECs’ very small market shares, the mergers of ILECs and Interexchange Carriers (“IXCs”), and the Regional Bell Operating Companies’ (“RBOCs”) Section 271

¹ *In the Matter of Access Charge Reform, Reform of Access Charges Imposed by Competitive Local Exchange Carriers*, Seventh Report and Order and Further Notice of Proposed Rulemaking, CC Docket No. 96-262, rel. April 27, 2001, ¶¶ 6-7 (hereafter “CLEC Access Reform Order”).

² *CLEC Access Reform Order*, ¶7.

³ *Id.*

⁴ For example, the primary complaint made by benchmarking proponents is that CLEC intrastate rates exceed ILEC rates and therefore, they must be too high.

⁵ As we will show, exchange access rates for even a single company such as AT&T vary routinely by a factor of ten across the country.

approval to provide inter-LATA long distance services. None of these are consistent with claims that CLECs are able to exercise market power.

Regulators must recognize that benchmarking policies deeply disrupt the CLECs' ability to compete viably. While exchange access rates are generally compensatory for ILECs, benchmarked rates are not for CLECs. CLECs incur demonstrably higher per-unit costs in the provision of exchange access services than the large ILECs and benchmarked rates leave a significant portion of the CLECs' cost unrecovered. This is unfair and possibly confiscatory: when the FCC established the price cap regime for LECs, it explicitly recognized that below-cost rates might be confiscatory:

[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*.⁶

Regulators should also note that benchmarking policies will not serve ratepayers well. CLECs will be forced to forfeit millions of dollars when IXC's gain access to their networks at below cost rates.⁷ This permanent drain on their resources will curtail the CLECs' ability to expand their networks and do great harm to the vibrancy of telecom markets.

Further, regulators should not expect to see IXC's lowering long distance rates in light of forced reductions in CLEC exchange access rates. CLECs simply represent too small a portion of the IXC's exchange access costs to drive any noticeable changes in long distance rates (i.e., the possible benefit to consumers when measured against the potential harm to competition generally is miniscule).⁸ Also, as we discuss, recent trends in long distance rates are not necessarily down. That is, AT&T, Qwest and Verizon are just as likely to pocket the money they save, when they are permitted to originate and terminate on CLEC networks at below-cost rates, than to flow it through to lower long distance rates. To be clear: the beneficiaries of benchmarking policies will primarily be AT&T, Qwest and Verizon shareholders – not the general body of telecommunications users.

All these arguments aside, the FCC has now finally decided that it must resolve inter-carrier compensation issues in a more comprehensive manner. In view of this, it would

⁶ *Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers*, CC Docket Nos. 96-262 and 94-1, Sixth Report and Order, *Low-Volume Long Distance Users*, CC Docket No. 99-249, Report and Order, *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Eleventh Report and Order, 15 FCC Rcd 12962 (2000) (hereafter "*CALLS Order*"), ¶ 17.

⁷ The suggestion that CLECs can recoup those costs from end users, offered by advocates of benchmarking policies, is disingenuous – retail markets are competitive and do not permit arbitrary markups for unrecovered costs.

⁸ Of course, if the objective were to promote lower long distance rates, regulators would be far wiser to adjust the rates for independent ILECs, who terminate more calls on their networks than CLECs and at generally higher rates.

be particularly ill-timed and ill-considered for state commissions to decide to follow poorly reasoned federal benchmarking policies.⁹

⁹ On July 8, 2008, the United States Court of Appeals for the District of Columbia Circuit granted Core Communications Inc.'s writ of mandamus and directed the FCC to explain the legal basis for its ISP-bound compensation rules within six months. The court ruled that the FCC's ISP-bound compensation rules would be vacated if no such explanation is provided by the FCC within the specified timeframe. *In Re: Core Communications, Inc.* No. 07-1446, Decided July 8, 2008. Counsel for the FCC indicated in oral arguments in that case that FCC Chairman Martin "intends to achieve broad-based comprehensive intercarrier compensation reform within six months." *In Re: Core Communications, Inc.*, D.C. Cir. Civ. No. 07-1446, Transcript of May 5, 2008 Oral Argument, at 22 (Palmore comments).

I. INTRODUCTION

In 2001, the Federal Communications Commission (“FCC”) adopted benchmarking policies that prohibited competitive local exchange carriers (“CLECs”) from tariffing interstate exchange access rates (often referred to as “switched access charges”) at levels *higher* than those of incumbent local exchange carriers (“ILECs.”)¹⁰ Recently, large ILECs and their interexchange carrier (“IXCs”) affiliates and other parties are asking state regulatory commissions to mirror the FCC’s benchmarking policies for intrastate exchange access rates.¹¹ As we will discuss in this paper, there are a large number of reasons why the FCC’s benchmarking policies are poorly constructed and why state commissions would be ill-advised to use them as a model for intrastate rates.

First, drawing on a large database of exchange access rates, we will present a comparison of the rates charged by large ILECs, CLECs and small and mid-sized ILECs. This comparison demonstrates that concerns about CLEC exchange access rates are misplaced: CLEC exchange access rates as a whole are at reasonable levels and consistent with *a priori* considerations regarding CLEC network architecture, costs, customer densities, etc. Of course, CLEC exchange access rates are, on average, higher than those of the largest ILECs, but they should be. As we will show, CLECs, like small and mid-sized ILECs, tend to have higher costs than large ILECs. The fact that CLEC intrastate exchange access rates are generally higher than those of the large ILECs is, by no means, indicative of a market failure.

Second, we will discuss that the FCC did not intend for its benchmarking policies to be permanent; rather, they were adopted as transitional placeholders until more comprehensive and rational inter-carrier compensation policies could be adopted: “We stress, however, that the mechanism set out below is a transitional one; it is not designed as a permanent solution to the issues surrounding CLEC access charges.”¹² The FCC indicated that it would develop a more permanent solution within the broader context¹³ of

¹⁰ *In the Matter of Access Charge Reform, Reform of Access Charges Imposed by Competitive Local Exchange Carriers*, Seventh Report and Order and Further Notice of Proposed Rulemaking, CC Docket No. 96-262, rel. April 27, 2001, ¶¶ 6-7 (hereafter “CLEC Access Reform Order”).

¹¹ *See, e.g.*, California Public Utilities Commission, *Order Instituting Rulemaking to Review Policies Concerning Intrastate Carrier Access Charges*, CAPUC Decision 07-12-020; Rulemaking 03-08-018, December 6, 2007 [2007 Cal. PUC LEXIS 609]. In this Order, the California Public Utilities Commission required “Competitive local exchange carriers [to] reduce their intrastate access charges to \$ 0.025 per minute effective April 1, 2008, and then to the higher of AT&T’s or Verizon’s intrastate access charges, plus 10%, effective January 1, 2009.” On June 17, 2008, the Florida Public Service Commission Staff announced a workshop to be held on CLEC exchange access rates on July 16, 2008. The Illinois Commerce Commission Staff recently held a series of workshops on CLEC exchange access charges, and ultimately decided not to initiate a general proceeding on the topic but instead address any problematic CLEC exchange access rates on a case-by-case basis.

¹² *CLEC Access Reform Order*, ¶7.

¹³ *Id.*, ¶7.

inter-carrier compensation.¹⁴ While the FCC has, seven years later, failed to adopt a more comprehensive regime, the agency recently indicated that it is now ready to resolve the various inter-carrier compensation issues, including issues related to interstate exchange access.¹⁵ Aside from all other problems with benchmarking policies, any efforts to have state commissions adopt benchmarking policies at this juncture are particularly ill timed.

Next, the FCC explained that its “one-size-fits-all” policies were due in part to resource constraints: the FCC stressed its limited ability to deal with possible abuses through its complaint process.¹⁶ State commissions, while smaller than the FCC, deal with far fewer carriers and there is no reason why they should not continue to address any anomalies through their complaint processes.

Further, we will demonstrate that the FCC’s policies have been overtaken by market events and are no longer relevant to current telecommunications markets. Since 2001, the industry has undergone watershed changes, most notably the megamergers of AT&T/SBC and Verizon/MCI, and the Regional Bell Operating Companies’ (“RBOCs”) Section 271 approvals for entry into long distance markets. The local exchange industry has also seen an increased presence of cable based providers, offering services over alternative local networks. These changes, and many others, have a direct bearing on the question of whether CLEC exchange access rates should be regulated. Specifically, in 2001, the FCC identified two prerequisites for functioning exchange access markets: (1) alliances between IXCs and ILECs, and (2) IXC entry into local exchange markets.¹⁷ As the FCC noted, both of these events would have imposed market discipline on exchange access rates. While the FCC correctly observed that IXCs in 2001 had difficulties entering local exchange markets due to various barriers-to-entry, today, that is no longer true. Today, alliances have been struck; and the large IXCs are fully aligned with their ILEC affiliates. As a result, IXCs have ample alternatives to the CLECs’ facilities to reach their end users. If nothing else, the large IXCs now have access to all the necessary local exchange facilities through their ILEC affiliates. In short, the considerations which

¹⁴ *Id.*, referencing *Developing a Unified Inter-carrier Compensation Regime, Notice of Proposed Rulemaking*, CC Docket Nos. 01-92, 99-68, 96-98, FCC 01-132 (rel. April 27, 2001) (*Inter-carrier Compensation NPRM*)

¹⁵ On July 8, 2008, the United States Court of Appeals for the District of Columbia Circuit granted Core Communications Inc.’s writ of mandamus and directed the FCC to explain the legal basis for its ISP-bound compensation rules within six months. The court ruled that the FCC’s ISP-bound compensation rules would be vacated if no such explanation is provided by the FCC within the specified timeframe. *In Re: Core Communications, Inc.* No. 07-1446, Decided July 8, 2008. Counsel for the FCC indicated in oral arguments in that case that FCC Chairman Martin “intends to achieve broad-based comprehensive intercarrier compensation reform within six months.” *In Re: Core Communications, Inc.*, D.C. Cir. Civ. No. 07-1446, Transcript of May 5, 2008 Oral Argument, at 22 (Palmore comments).

¹⁶ *CLEC Access Reform Order*, ¶25: “We are concerned that a flood of unreasonable-rate complaints could overtax the Commission’s resources to deal with such proceedings in a manner that is timely and efficient yet gives each complaint the attention it deserves.”

¹⁷ *CLEC Access Reform Order*, ¶32.

led the FCC to conclude in 2001 that IXCs were beholden to CLECs are no longer relevant and neither is the rationale for benchmarking policies.

Next, we will discuss why benchmarking policies distort price signals essential to properly functioning telecommunications markets. Benchmarking policies would deny CLECs adequate compensation for legitimately incurred costs. But, when CLECs are unable to recover their exchange access costs from the IXCs – the true cost causers – they will be forced to attempt to recover those costs from other, non-IXC customers, lest these costs go entirely unrecovered (which is not sustainable). As such, the artificial price caps inherent in benchmarking policies will invariably lead to unwarranted cross-subsidizations schemes. Of course, it is unlikely that CLECs will be able to shift all of the unrecovered costs onto other their non-IXC customers: competitive markets do not tolerate such arbitrary cost shifts.

We will also demonstrate that benchmarking policies are likely to bolster AT&T's and Verizon's superior bargaining positions – i.e., their monopsony¹⁸ powers – that already allow these companies to dominate CLECs in negotiations about exchange access rates and payments. This would not only be disruptive to functioning exchange access markets but also of local exchange retail competition. We will demonstrate that AT&T and Verizon are leveraging their monopsony powers at the wholesale level into additional competitive advantages at the retail level. By squeezing the CLECs' wholesale revenues streams, AT&T and Verizon are siphoning off the funds CLECs need to compete viably in retail markets. Thus, by undermining the CLECs' financial strength and bargaining position in exchange access negotiations, benchmarking policies could serve to irrevocably damage retail local exchange competition.

Furthermore, advocates of benchmarking policies often argue that the ILECs' exchange access rates should serve as proxies for competitive market rates, which CLECs should be required to match. This notion is misguided: the ILECs' intrastate and interstate exchange access rates in no way resemble competitive market rates. The ILECs' exchange access rates have historically been established as part of complex negotiations, which involved “horse-trading” and quid pro quos between many parties with conflicting interests. There is no reason why the ILECs' rates would have any merit when lifted out of the *specific context of the overall deal* struck between the ILECs and other interested parties. The truth is that the regulatory process used to establish exchange access rates for the large ILECs could not be more different than the process through which competitive market rates are established. Further, as we will show, the large ILECs' exchange access rates, rather than being uniform, like competitive market rates might be,

¹⁸ The term *monopsony* refers to a situation in which a large dominant buyer is able to dictate terms and conditions to its suppliers. A monopsonist has the market power to set the price of whatever it is buying (from raw materials to labor). An example of a monopsonist is Wal-Mart, which is known to be able to dictate terms and conditions to its suppliers, almost to the point of driving them out of business. Under perfect competition, by contrast, no individual buyer is big enough to affect the market price of anything. (See www.economist.com)

are all over the board – which is precisely what one would expect, given the deal-making that traditionally has established the ILEC rates.

Next, we will demonstrate that benchmarking policies are at odds with longstanding regulatory practices of establishing wholesale rates commensurate with company specific costs. Whether it concerns exchange access rates, rates for the ILECs' resale products or unbundled network elements ("UNEs"), the touchstone for just and reasonable rates is invariably *company specific costs*. Benchmarking policies radically deviate from this sound tradition and without good cause.

Finally, we will discuss that CLECs have more in common with smaller and mid-sized ILECs than with large ILECs in terms of customer densities and other cost considerations. This means that, in any comparison between CLECs and ILECs, CLEC exchange access rates should be compared with those of small and mid-sized ILECs and not with the large ILECs, such as AT&T and Verizon.

In sum, this paper demonstrates that requiring CLECs to benchmark their intrastate exchange access rates to those of large ILECs will cause a host of distortions, strengthen the monopsony power of the large IXCs/ILECs and invariably damage local competition.

II. CLEC EXCHANGE ACCESS RATES ARE GENERALLY REASONABLE – THERE IS NO *SYSTEMIC* "PROBLEM"

Some regulators have expressed concerns that CLEC exchange access rates are unreasonably high and have examined benchmarking as a potential solution to this alleged problem. Our research on exchange access rates indicates, however, that, on the whole, these concerns are misplaced. This section provides results of QSI's survey of exchange access rates charged by carriers across the United States and shows that most CLEC exchange access rates are reasonable when compared to rates of other carriers. That is, there is no systemic "problem" to be solved.

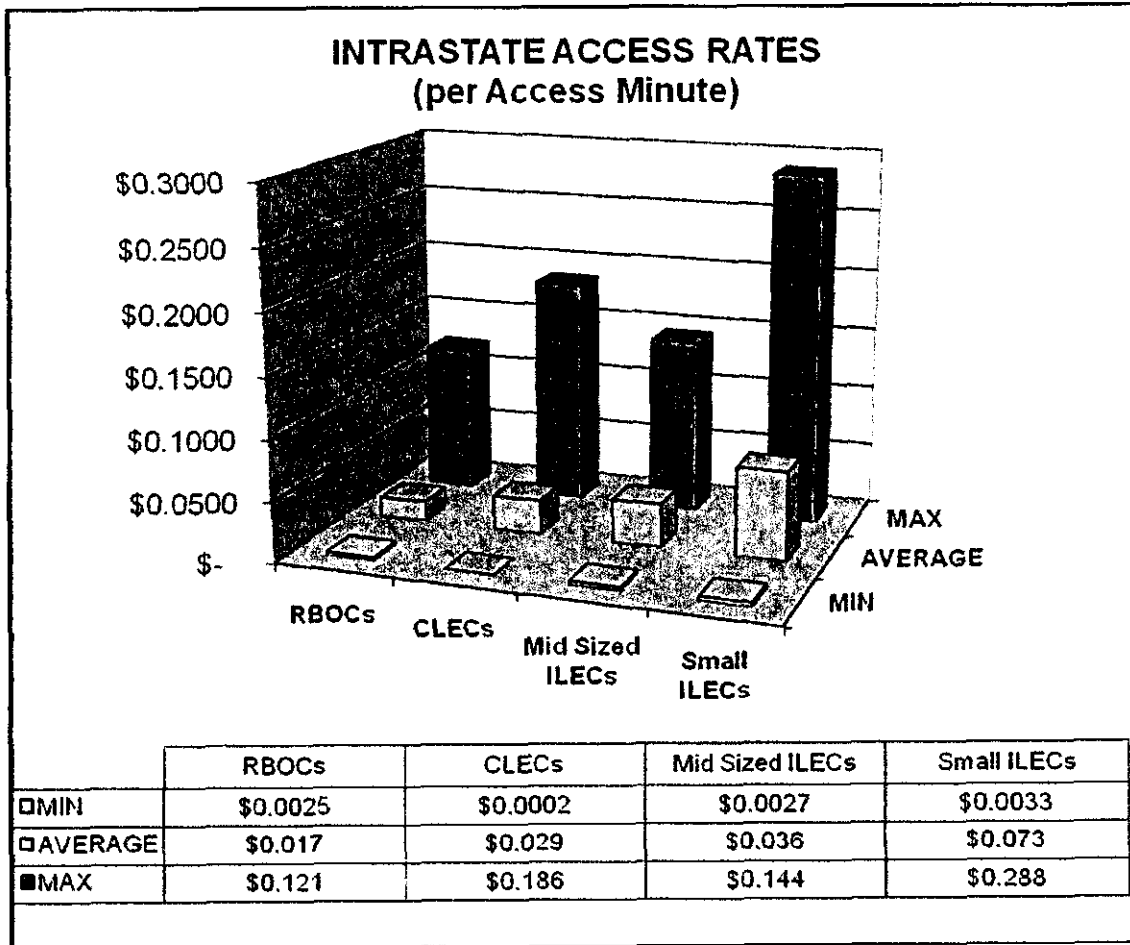
QSI pulled exchange access rates of various companies¹⁹ and calculated the composite per minute access rates – the aggregated rates that permit comparisons between carriers.²⁰ The composite rates of individual carriers in each jurisdiction were grouped by the type

¹⁹ The starting point of QSI's survey was the Telview access rate database, which QSI supplemented with access rate information for companies that do not appear in the Telview database – information that QSI derived directly from CLECs and ILECs access tariffs. QSI included in this survey tariff information on all CLECs that it was able to locate, which was more than 400 CLECs.

²⁰ The composite rates presented below are rates per access minute of use (one side of a long-distance call). They were calculated based on a scenario that a call is routed via tandem transport with transport mileage of 10 miles. Because smaller companies often do not own a tandem, the tandem switching rates are not included in the calculation of the composite rates in order to make an apples-to-apples comparison. In cases where rates were zoned or differentiated according to direction or time of day, a straight average of the differentiated values was used.

of carrier to produce an average exchange access rate by type of carrier.²¹ The types of carriers included RBOCs, mid-sized ILECs,²² CLECs and Small ILECs, with NECA carriers reported as a separate group in the interstate jurisdiction. The survey included rates of approximately 1,200 tariff entities (carrier-state combinations), including all RBOCs, all mid-sized ILECs, NECA, over 400 CLECs, and over 400 small ILECs (other than the NECA tariff).

The charts below summarize the results of the access rate survey. The first two charts depict the intrastate and interstate exchange access charges and their variations, underscoring the fact that there is no single “universal” level of access charges. The third chart compares the average intrastate and interstate access rates by carrier type.



²¹ Because the purpose of the study was to measure variation in rates, the aggregation was done as a simple average between tariff entities (rather than a weighted average).

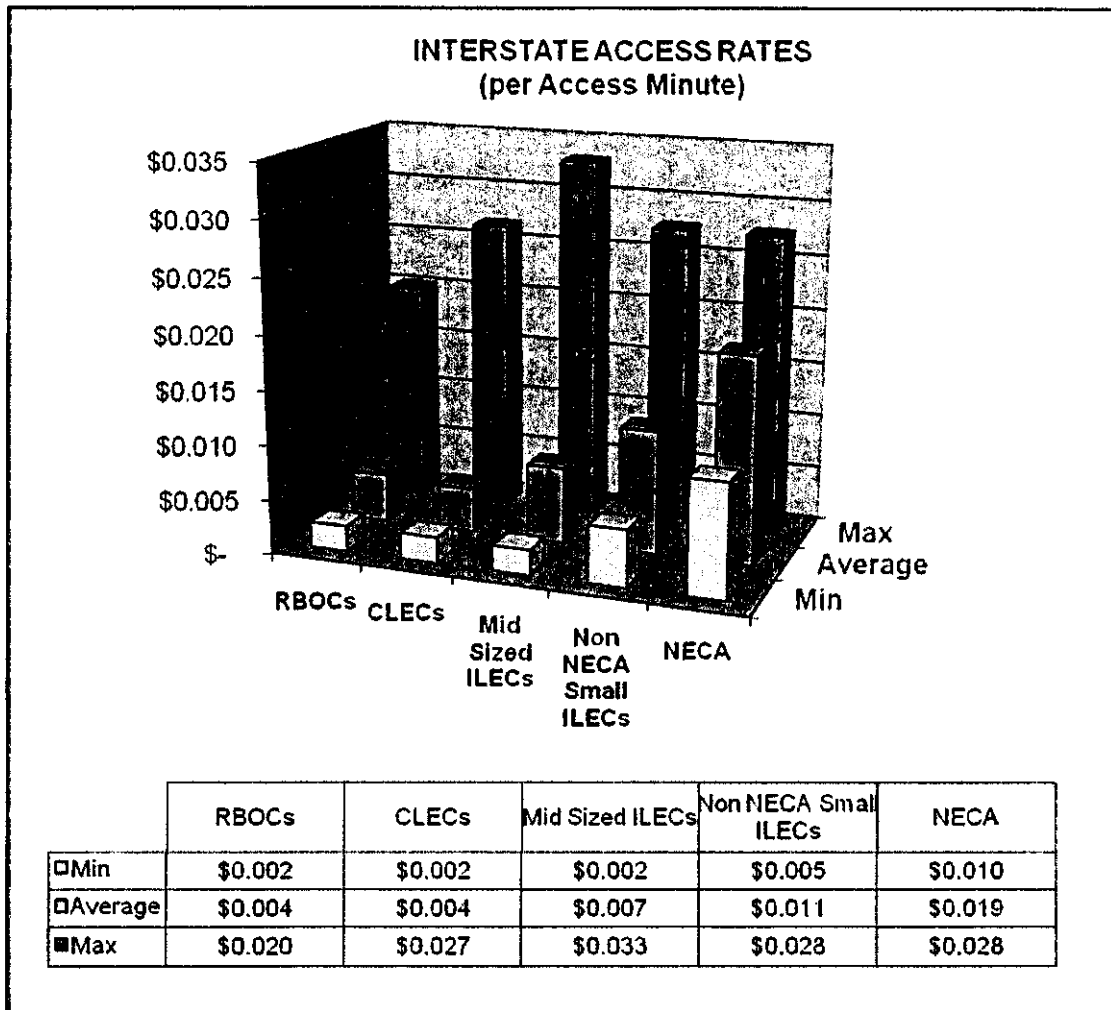
²² These are typically the non-RBOC ILECs that are price-cap regulated in the interstate jurisdiction.

As shown in the above chart, CLEC intrastate exchange access rates are, on average, higher than the large ILECs/RBOCs' rates, *but lower than the rates of mid-sized ILECs*. A comparison of the minimum and maximum rates shows that a CLEC has the lowest minimum rate and a higher maximum rate (when compared to large ILECs/RBOCs and mid-sized ILECs), which could indicate the presence of outlier carriers. Small ILECs have significantly higher exchange access rates than the other types of carriers in all three comparison categories (i.e., minimum, maximum and average).

It is important to note that these results are consistent with cost and network architecture considerations. As we will discuss below, CLECs look more like small and mid-sized ILECs, in terms of customer density and cost structure, than they look like large ILECs/RBOCs, so it is logical that CLEC exchange access rates would be higher than the large ILECs'/RBOCs' rates but lower than the small and mid-sized ILECs – the very point demonstrated by the above chart.

Further, despite the average exchange access rate for small, rural ILECs being two and a half times that of the average CLEC exchange access rate, regulators tend to exclude small, rural ILECs from benchmarks for exchange access rates. Given that CLECs have similar cost characteristics to these small ILECs, yet have exchange access rates that are, on average, far below the small ILECs' rates, it is fundamentally unreasonable for CLECs to be singled out for exchange access rate caps.

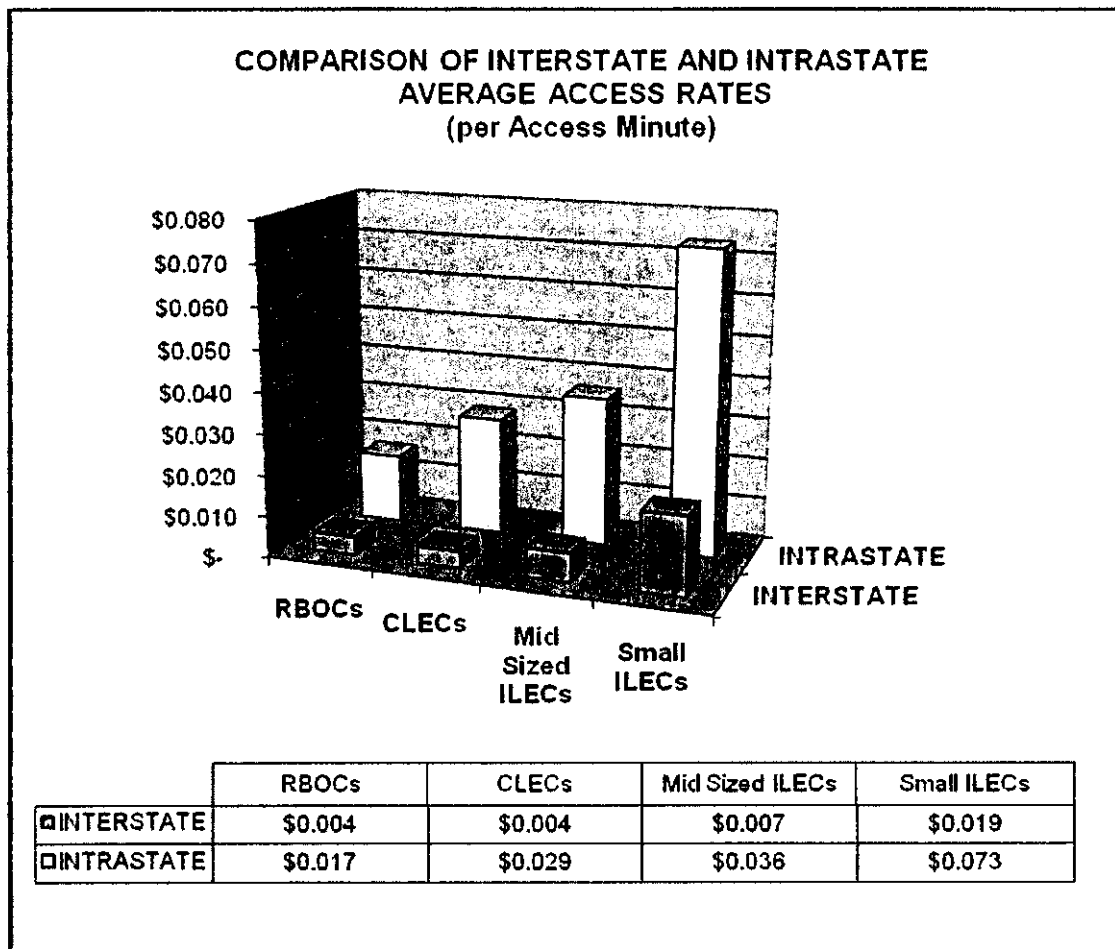
The next chart depicts the interstate access rates, sorting types of carriers in ascending order of their average exchange access rates:



This chart depicts results similar to the chart of intrastate rates in the sense that CLECs are positioned between large ILECs/RBOCs and Mid Sized ILECs, and small ILECs (both NECA and non-NECA) have significantly higher rates than the three other groups. We should note that the survey of interstate rates was not as comprehensive as a survey of intrastate rates, utilizing a smaller sample of non NECA ILECs and CLECs.²³ Further, given the FCC's benchmarking policy for interstate switched access rates that keeps CLEC exchange access rates at artificially low levels, these results are less illustrative than those of the intrastate rates.

²³ Note: the QSI survey did not include a comprehensive data set of CLEC interstate exchange access rates primarily because CLEC interstate access rates are capped at the rates of the ILECs in which territories the CLECs operate.

Finally, the chart below compares the average intrastate and interstate access rates by carrier type.²⁴



As shown above, for both interstate and intrastate exchange access charges, the CLEC rate levels generally fall between the large ILECs/RBOCs and the medium size and small ILECs.²⁵

This data demonstrates that the driving force behind attempts to require benchmarks for CLEC exchange access rates – that CLEC exchange access rates are unreasonably high – is based on a false premise. In other words, the problem that large ILECs/IXCs are attempting to convince regulators of simply does not exist.

²⁴ These rates appear in the two previous charts. For Small ILECs, NECA rate is picked for the interstate jurisdiction because of the large number of carriers in the NECA pool.

²⁵ The above graph also shows that for all four carrier types – RBOCs, CLECs, Mid Sized ILECs and Small ILECs – intrastate rates are significantly higher than the interstate rates. This observation underscores the fact that the current access rates are a cumulative result of the convoluted history of access charge regulation, rather than a set of “objective” rates.

III. THE FCC'S BENCHMARKING POLICIES WERE NEVER INTENDED TO BE PERMANENT AND ARE NO LONGER RELEVANT TO THE CURRENT STATE OF TELECOMMUNICATIONS

In its *CLEC Access Reform Order* the FCC adopted the following benchmarking policy:

Under the detariffing regime we adopt, CLEC access rates that are at or below the benchmark that we set will be presumed to be just and reasonable and CLECs may impose them by tariff. Above the benchmark, CLEC access services will be mandatorily detariffed, so CLECs must negotiate higher rates with the IXCs. During the pendency of negotiations, or if the parties cannot agree, the CLEC must charge the IXC the appropriate benchmark rate. We also adopt a rural exemption to our benchmark scheme, recognizing that a higher level of access charges is justified for certain CLECs serving truly rural areas.²⁶

It is important to note that the FCC's benchmarking policies were motivated by two considerations that make adoption of the FCC's policies by state commissions particularly inappropriate: the policies were adopted as *transitional* and in the face of *resource* constraints. Moreover, the telecommunications industry has undergone a fundamental transformation since the FCC's order, such as the megamergers and Section 271 approvals for RBOCs to engage in interLATA long distance competition. Thus, while the FCC's benchmarking policies may have addressed issues that were relevant in 2001, they are no longer relevant to the current state of the industry.

A. The FCC's Benchmarking Policies Were Never Intended to Be Permanent

The FCC explicitly noted that its benchmarking policies were intended as *transitional*, awaiting the FCC's more permanent resolution of inter-carrier compensation issues:

We stress, however, that the mechanism set out below is a *transitional* one; it is not designed as a permanent solution to the issues surrounding CLEC access charges. Rather, we view the mechanism we adopt today as a means of moving the marketplace for access services closer to a competitive model. Because our tariff benchmark is tied to the incumbent LEC rate, we will re-examine these rates at the close of the period specified in the *CALLS Order*. Through a separate notice of proposed rulemaking that we issue today, we also evaluate the access charge scheme as part of a broader review of inter-carrier compensation.²⁷

²⁶ *CLEC Access Reform Order*, ¶ 3.

²⁷ *Id.* ¶ 7. (Emphasis added.)

As recently indicated, the FCC is likely to comprehensively address inter-carrier compensation issues in the very near future.²⁸ Therefore, irrespective of a host of other problems concerning benchmarking policies, any effort to emulate the FCC's benchmarking policies now is particularly ill timed.

B. The FCC's Benchmarking Policies Were Adopted in the Face of Resource Constraints

The results of QSI's exchange access rate survey demonstrates that, on average, CLEC exchange access rates are not unreasonably high, suggesting that "broad brush" approaches, such as capping all CLEC intrastate exchange access rates, are an unwarranted regulatory intrusion. It appears that any concerns about particular CLEC exchange access rates are far more effectively addressed on an individual case basis through the complaint process.

Nevertheless, in adopting its benchmarking policies, the FCC noted that the complaint process may strain the FCC's resources:

Several parties have already filed with the Commission informal complaints raising this issue in order to preserve their claims from lapse. We are concerned that a flood of unreasonable-rate complaints could *overtax the Commission's resources* to deal with such proceedings in a manner that is timely and efficient yet gives each complaint the attention it deserves.²⁹

While the FCC regulates thousands of IXCs and CLECs across all fifty states, state commissions deal with far fewer carriers. And given that CLECs, on average, have reasonable intrastate exchange access rates in the first place, state commissions do not face the same resource constraints that led the FCC to adopt a benchmark requirement. State regulatory commissions are well positioned to deal effectively with individual and isolated situations that may arise regarding outlier CLEC exchange access rates through their existing complaint processes, and there is no need to resort to a one-size-fits-all approach, such as benchmarking.

²⁸ On July 8, 2008, the United States Court of Appeals for the District of Columbia Circuit granted Core Communications Inc.'s writ of mandamus and directed the FCC to explain the legal basis for its ISP-bound compensation rules within six months. The court ruled that the FCC's ISP-bound compensation rules would be vacated if no such explanation is provided by the FCC within the specified timeframe. *In Re: Core Communications, Inc.* No. 07-1446, Decided July 8, 2008. Counsel for the FCC indicated in oral arguments in that case that FCC Chairman Martin "intends to achieve broad-based comprehensive intercarrier compensation reform within six months." *In Re: Core Communications, Inc.*, D.C. Cir. Civ. No. 07-1446, Transcript of May 5, 2008 Oral Argument, at 22 (Palmore comments).

²⁹ *Id.* ¶ 25. (Emphasis added.)

C. The FCC's benchmarking Policies Are no Longer Relevant to the Current State of Telecommunications

In its *Access Reform Order*, the FCC recognized the presumptively competitive nature of CLEC exchange access services:

[A]s CLECs attempted to expand their market presence, the rates of incumbent LECs or other potential competitors should constrain the CLECs' terminating access rates. The Commission found that access customers likely would take competitive steps to avoid paying unreasonable terminating access charges. Thus, it explained that a call recipient might switch to another local carrier in response to incentives offered by an IXC.³⁰

When the FCC revisited the issue in its *CLEC Access Reform Order* to address what IXCs viewed as "the CLECs' abuse of [the FCC's] tariff rules to impose excessive access charges"³¹ it came to an *opposite* conclusion. The FCC noted:

We decline to conclude, in this order, that CLEC access rates, across the board, are unreasonable. Nevertheless, there is ample evidence that the combination of the market's failure to constrain CLEC access rates, our geographic rate averaging rules for IXCs, the absence of effective limits on CLEC rates and the tariff system create an arbitrage opportunity for CLECs to charge unreasonable access rates. Thus, we conclude that some action is necessary to prevent CLECs from exploiting the market power in the rates that they tariff for switched access services.³²

However, while the FCC concluded that CLECs may be able to exploit market power, it is important to note that the FCC explicitly identified *two developments* that would make exchange access markets competitive:

The Commission previously projected that, at least in the case of originating access service, IXCs would likely enter marketing alliances with LECs offering low-priced access service and would thereby be able to exert downward pressure on CLEC access rates. The Commission even raised the prospect that IXCs would themselves choose to enter the local service market as a means of exerting downward pressure on terminating rates.³³

³⁰ *CLEC Access Reform Order*, ¶ 14.

³¹ *Id.*, ¶ 1.

³² *Id.*, ¶ 34.

³³ *CLEC Access Reform Order*, ¶32.

That is, exchange access markets would discipline CLEC exchange access rates if the following occurred:

1. Alliances between IXC and ILECs.
2. IXC entry into local exchange markets.

In 2001, the FCC lamented that neither of these developments had come to pass and, accordingly, the FCC concluded that CLECs must have market power in the provision of exchange access services:

However, neither of these eventualities has come to pass, at least not to an extent that has resulted in effective downward competitive pressure on CLEC access rates. We now acknowledge that the market for access services does not appear to be structured in a manner that allows competition to discipline rates.³⁴

Of course, what the FCC was hoping for in 2001 – alliances between IXCs and ILECs and IXC entry into local markets – now *has* come to pass. All RBOCs have obtained Section 271 approval to provide interLATA long distance services, and perhaps more importantly, there have been a number of mergers between IXCs and ILECs – most notably the *megamergers* between AT&T and SBC and Verizon and MCI – which have further transformed the traditional ILECs into vertically integrated firms that offer local and long distance services. The watershed changes brought about by the megamergers and Section 271 approvals impact and alter any conclusions regarding the CLECs' ability – or lack of ability – to exercise market power due to any alleged barriers-to-entry faced by IXCs. Indeed, given that AT&T, Qwest and Verizon own and operate most of the country's local loop facilities, it must now be concluded that their IXC affiliates no longer face any barriers to entry. Ultimately, the rationales that the FCC relied upon for finding CLEC market power and requiring exchange access rate benchmarks are no longer valid.

Absent barriers to entry, CLECs will simply not be able to exercise market power. Through their affiliates, IXCs have general access to local exchange facilities and would be able to compete for any customers associated with excess revenues (whether they are generated from retail services or wholesale services.) *Thus, competition in retail markets now disciplines market behavior in upstream wholesale markets for exchange access markets.*

For example, if a CLEC raises its exchange access rates to earn supernormal profits, then the CLEC's customers will become especially attractive to all would-be competitors, including the large IXCs' ILEC affiliates. Companies compete not only for the *retail* revenues and profits associated with an end user but for *all* revenues and profits associated with the end user. (These revenues and profits also include revenues and

³⁴ *Id.*, ¶32. (Emphasis added.)

profits generated from inter-carrier services, including exchange access revenues.) Absent barriers to entry to large IXCs and their ILEC affiliates, there is nothing in the post megamerger era that would permit the CLEC to retain a customer associated with higher revenues and profits. Other carriers will, one way or another³⁵, compete the customer away. In fact, to assume that other carriers would *not* compete for customers associated with higher revenues and profits is irrational.

D. The FCC Failed to Do a Complete and Formal Market Dominance Analysis

While the FCC's benchmarking policies have been overtaken by events in the industry, it must also be recognized that the FCC never performed a complete and formal market dominance analysis to determine whether CLECs, in 2001, had market power.

In fact, the FCC's market dominance analysis in its *CLEC Access Reform Order* stands in stark contrast to the more systematic and formal market dominance analyses the FCC has performed in other proceedings. For example, in its *Qwest Omaha Forbearance Order*, the FCC delineated the basics for a market dominance analysis as follows:

[T]he Commission determines whether a carrier is dominant by: (1) delineating the relevant *product* and *geographic* markets for examination of market power; (2) identifying firms that are current or potential suppliers in that market; and (3) determining whether the carrier under evaluation possesses individual market power in that market.³⁶

In its *CLEC Access Reform Order*, by contrast, the FCC failed to identify and consider any of the standard components of a market dominance analysis. The FCC failed to define the product market, the geographic market, current and potential suppliers, market share information and possible demand responses. As such, the FCC's conclusion that CLECs have market power in the provision of exchange access services is, essentially, unsupported.

To answer the question of whether CLECs have market power in the provision of exchange access services, we have conducted a formal market dominance analysis using a standard theoretical framework. The full details of the analysis are found in Attachment I.

³⁵ We say "one way or another" because markets are creative and we cannot predict beforehand all the many ways in which companies may lure customers away.

³⁶ *Qwest Omaha Forbearance Order*, ¶ 18. (*emphasis added*)

The framework we use is standard in economics and antitrust regulation, such as the Federal Trade Commission's ("FTC's") and the Department of Justice's ("DOJ's") *Horizontal Merger Guidelines*³⁷ and consists of the following steps:

1. A definition of market power.
2. A definition of the product market and the geographic dimensions of the market.
3. Market share analysis.
4. A final assessment of all demand and supply responses in reaction to an attempted exercise of market power: i.e., an assessment of whether or not the attempt will succeed or be defeated.

In our analysis, we use a definition of "market power" provided in the *Horizontal Merger Guidelines*:

Market power to a seller is the ability profitably to maintain prices above competitive levels for a significant period of time.³⁸

Implied in this definition is the notion that if a seller has market power, then the seller is earning supernormal profits. The FCC often uses a similar definition of market power; for example, in the *Qwest Omaha Forbearance Order* the FCC defined market power as follows:

Market power is defined as "the ability to raise prices by restricting output," or "to raise and maintain price above the competitive level without driving away so many customers as to make the increase unprofitable."³⁹

Given this definition⁴⁰, a claim that CLECs have market power must be supported by a demonstration that CLECs earn supernormal profits in the provision of exchange access services. The FCC, however, never made a serious attempt in its *CLEC Access Reform Order* to examine CLEC costs, revenues and profits.

Further, it must be noted that market power and supernormal profits can only be sustained if there are barriers to entry. *That is, market power requires the presence of barriers to entry.* Unfortunately, the FCC never even addressed the issue of barriers to entry in its *CLEC Access Reform Order*.

³⁷ 1992 Department of Justice/Federal Trade Commission *Horizontal Merger Guidelines*, 4 Trade Reg. Rep. (CCH) P13,104, at 20,569 ("*Horizontal Merger Guidelines*").

³⁸ *Horizontal Merger Guidelines* at Section 0.1 (emphasis added). U.S. DOJ and FTC Horizontal Merger Guidelines available at: http://www.usdoj.gov/atr/public/guidelines/horiz_book/toc.html

³⁹ *Qwest Omaha Forbearance Order* at note 54.

⁴⁰ While we have serious misgivings about the FCC's conclusions in its *Qwest Omaha Forbearance Order*, we do agree with the FCC's definition of market power.

Using a formal framework, we demonstrate the following:

- IXCs and their large ILEC affiliates no longer face significant barriers-to-entry:
 - IXCs (such as AT&T and Verizon) and their ILEC affiliates have near ubiquitous facilities and typically own and operate the last mile loop, switching and transport facilities necessary to provide exchange access to themselves, to others and to the end user. They have the technical, operational and customer relations (billing systems and information, etc) capability to do so on a sufficiently short-term basis.
 - IXCs (such as the vertically integrated AT&T and Verizon) already have a relationship – as IXCs, and often as wireless carriers – with the end user, thus facilitating local customer acquisition efforts.

That is, IXCs can compete for almost any end-user customer on short notice.

- CLECs, individually, have typically only a tiny market share, far below the 50 percent threshold typically used by courts under which market power is virtually never found.⁴¹ (We will discuss CLEC market shares in more detail below.)

In sum, based on the results of a formal market dominance analysis, we conclude that CLECs do not have market power in the provision of exchange access services. The full details of this market dominance analysis are found in Attachment I.

E. The Fallacy of Short-Run Analyses

Some industry observers have been tempted to conclude that CLECs have market power in the provision of exchange access services based on a short run analysis. The argument goes as follows: when an end-user makes or receives a long distance call, the IXC is obligated to originate or terminate the call at whatever prices CLECs may charge because there are no alternatives or substitutes available to the IXC related to that particular call. Therefore, the argument goes, the CLEC has market power.

While this argument may have superficial appeal, it is incorrect. Using this type of a short run analysis, many companies may appear to have monopoly power. For example, in the short run, airlines on cross-Atlantic flights have market power in the provision of on-flight food and beverage services for any particular flight, and they could charge excessive prices for bathroom access. In a slightly longer run analysis, however, it is clear that they have little or no market power and are, in fact, operating in a highly competitive environment. For example, if an airline attempted to charge a regular

⁴¹ See, e.g., A.B.A. Section of Antitrust Law, *Antitrust Law Developments* at 235-236 (4th ed.) (1997), cited in the FCC *Verizon Forbearance Order* at footnote 99.

competitive price for airline tickets and then an exorbitant amount for bathroom access on its flights, customers would likely decide not to fly on that airline and other airlines would surely swoop in to serve those passengers.

The truth is that a market dominance analysis should be premised on a *time horizon* that is *sufficiently long to permit for demand and supply responses to discipline market participants*.

In the current situation, the analysis should consider a longer run analysis in which other providers of exchange access, such as vertically integrated large ILECs/IXCs, are able to establish their own “exchange access” connection to the end-user. And given that most CLECs lease their loop facilities from AT&T and Verizon, those exchange access connections are already established by the vertically integrated large ILECs/IXCs. Therefore, the time horizon needs only to be sufficiently long for the competitive process of customer acquisition – or rather, the threat of customer acquisition – to play out. CLECs operate in a highly competitive environment in which they compete for all the revenues associated with the end-user, which includes not only the revenues from the local exchange and long distance services offered to the end-user, but also the revenues of exchange access services offered to IXCs. That is, in the intermediate run, retail competition disciplines the upstream wholesale markets.

F. CLECs Market Shares Are at Odds with Claims of Market Power

It is standard in a market dominance analysis to consider two sets of alternative providers who can apply competitive pressures: currently existing providers and potential entrants. The identification of alternative providers typically involves some assessment of relative market shares. The larger the market shares of existing alternative providers, the less likely it is that a firm can exercise market power.

The FCC follows this same general approach in market dominance analyses. For example, in the *Qwest Omaha Forbearance Order*, the FCC focused on the relative market shares of Qwest and its main competitors, specifically Cox Communications.

Given that the issue under investigation concerns whether or not CLECs have market power in the provision of exchange access services, the relevant question is: what are the market shares of CLECs, individually, relative to the total size of the market? As can be seen from the table below taken from the FCC’s Local Competition Report, collectively, CLECs still constitute but a small percentage of local exchange markets.⁴²

⁴² FCC *Local Competition Report*, 2007. Table 1.

End-User Switched Access Lines Reported

Date	ILEC Lines	CLEC Lines	Total	CLEC Share
Dec 1999	181,202,853	8,194,243	189,397,096	4.3 %
Jun 2000	179,648,725	11,557,381	191,206,106	6.0
Dec 2000	177,561,022	14,871,409	192,432,431	7.7
Jun 2001	174,752,275	17,274,727	192,027,002	9.0
Dec 2001	171,917,359	19,653,441	191,570,800	10.3
Jun 2002	167,330,006	21,644,928	188,974,934	11.5
Dec 2002	164,386,452	24,863,691	189,250,143	13.1
Jun 2003	158,274,538	26,985,345	185,259,883	14.6
Dec 2003	153,157,843	29,775,438	182,933,281	16.3
Jun 2004	147,993,218	32,033,915	180,027,133	17.8
Dec 2004	144,809,899	32,880,812	177,690,711	18.5
Jun 2005	143,757,708	33,975,336	177,733,044	19.1
Dec 2005	143,773,101	31,387,839	175,160,940	17.9
Jun 2006	142,293,047	29,896,109	172,189,156	17.4
Dec 2006	138,833,928	28,625,971	167,459,899	17.1
Jun 2007	134,458,920	28,711,461	163,170,381	17.6

Only LECs with at least 10,000 lines in a state were required to report through December 2004. Beginning with the June 2005 data all LECs are required to report. Some historical data have been revised.

While exact numbers for individual CLECs are not available, the individual market shares will obviously be only a fraction of the combined CLEC market share. To place the market share information in context of a market power analysis, one should recognize that courts virtually never find market power when market shares are less than 50 percent.⁴³ The FCC used approximately the same market share levels for assessing whether petitioners in forbearance petitions have market power.⁴⁴ The *combined* CLEC market share is a fraction of that threshold level and the *individual* CLEC market share would be a smaller fraction of that threshold.⁴⁵

The CLECs' relatively low market shares -- to be assessed on an individual basis -- are not even close to levels that may raise legitimate concerns of CLEC market power.⁴⁶

⁴³ A.B.A. Section of Antitrust Law, *Antitrust Law Developments* at 235-236 (4th ed.) (1997), cited in the FCC *Verizon Forbearance Order* at footnote 99.

⁴⁴ A.B.A. Section of Antitrust Law, *Antitrust Law Developments* at 235-236 (4th ed.) (1997), cited in the FCC *Verizon Forbearance Order* at footnote 99.

⁴⁵ Moreover, as the table indicates, collectively, CLECs are losing rather than gaining market share.

⁴⁶ Market share information must be interpreted relative to specific product market and geographic market definitions. Attachment I discusses this issue in more detail. At this point it may suffice, however, to note that in its *Triennial Review Order*, the FCC generally defined the market for switched based

G. The Triennial Review Order and Triennial Review Remand Order Determined That There Is No Impairment to Entry Stemming from Switching Related Facilities or Services

The FCC in its *Triennial Review Order* (“TRO”)⁴⁷ and again in its *Triennial Review Remand Order* (“TRRO”)⁴⁸ determined that local communications markets do not exhibit impairment as relates to switching-related facilities and services – which are the very facilities and services that support exchange access. For example, in the *TRRO* the FCC found:

We conclude, based on the record here, and the reasonable inferences we draw from it, that competitive LECs not only have deployed a significant, growing number of their own switches, often using new, more efficient technologies such as packet switches, but also that they are able to use those switches to serve the mass market in many areas, and that *similar deployment is possible in other geographic markets*. Additionally, we find that the BOCs have made significant improvements in their hot cut processes that should better situate them to perform larger volumes of hot cuts (“batch hot cuts”) to the extent necessary. We find that these factors substantially mitigate the *Triennial Review Order*’s stated concerns about circuit switching impairment.⁴⁹

The positions taken by the FCC in its *TRO* and *TRRO* (which removed the unbundling requirements for ILEC switching) and *CLEC Access Reform Order* (which imposed price regulation on CLEC exchange access services) are fundamentally inconsistent.⁵⁰ *either switching-related facilities and services are a source of significant market power or they are not.*

Further, the FCC decided that its “non-impairment” finding was consistent with its desire to foster “facilities based competition.” Yet, the FCC’s CLEC exchange access policies – which cause under-recovery of traffic sensitive switching related costs – harm the very carriers that are expected to deploy their own switching and transport facilities. That is,

products at the level of the metropolitan Statistical Area (“MSA”), and not at the customer level. The same is true in the *Qwest Omaha Forbearance Order*.

⁴⁷ *In the Matter of 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 No. 01-338/96-98/98-147, Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, FCC 03-36, Rel. August 21, 2003 (“*Triennial Review Order*” or “*TRO*”).

⁴⁸ *In the Matter of Unbundled Access to Network Elements, Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, WC Docket No. 04-313, CC Docket No. 01-338, FCC 04-290, rel. February 4, 2005 (“*Triennial Review Remand Order*” or “*TRRO*”).

⁴⁹ *TRRO*, ¶ 199. (emphasis added)

⁵⁰ By referring to the *TRRO*, QSI does not imply that it agrees with the FCC’s findings in the *TRRO*. We only use it to illustrate the inconsistencies in the FCC’s reasoning and findings.

the FCC's analysis and objectives in its *TRRO* are at odds with its analysis and policies (including the benchmarking policy) in its *CLEC Access Reform Order*.

H. Existing Policies Distort Price Signals in Access Markets

The FCC has previously interpreted section 254(g) of the Act as requiring IXCs to spread the cost of exchange access among all of their end users.⁵¹ This means that, under the FCC's current policies, IXCs are not allowed, in billing their end users, to pass through the actual cost of exchange access and thus cannot send their end users accurate price signals. Many state regulations likewise require geographic long distance price averaging. While the pursuit of universal service may serve public policy objectives, it also, as most price regulations do, stymie proper price signals and end up distorting exchange access markets.

i. *Prohibitions on De-averaging Long Distance Rates Stymie Price Signals*

The prohibitions on de-averaging of long distance rates, such as under the FCC's current interpretation of section 254(g) of the Act, generally prevent IXCs from reflecting in their long distance rates variations in exchange access costs. For example, IXCs are prohibited from signaling to end user customers when calls are expensive to terminate and when they are less expensive to terminate, which distorts the demand responses of end users. By de-averaging, for example, IXCs could differentiate long distance prices to reflect the relative cost of exchange access, and as a result, end users would be more apt to respond to the cost of exchange access based on the associated price of long distance services. By analogy, if IXCs were prohibited from differentiating their international calling charges between different countries, one can only imagine the serious distortions that would be introduced as IXCs attempted to average international rates across many different countries and varying access costs. Conceptually, regulations that prohibit IXCs from de-averaging long distance rates to reflect variations in exchange access rates are no different. Another analogy involves the airline industry, in which airlines incur airport taxes, which are similar to originating and terminating exchange access rates paid by IXCs. However, the airlines are mostly unaffected⁵² by these taxes because they are allowed to flow them through to end users in the ticket prices (which are completely deregulated). The IXCs could do the same as airlines except for the prohibitions on de-

⁵¹ See Order ¶ 11 & n.15; *Policy and Rules Concerning the Interstate, Interexchange Marketplace, Implementation of § Section 254(g) of the Communications Act of 1934, as amended*, Report and Order, 11 FCC Rcd 9564, ¶ 9 (1996).

⁵² Of course, there is a demand effect: to the extent that airport taxes cause ticket prices to increase, airlines are affected since it may discourage some customers from flying. However, prohibiting airlines from reflecting variations in airport taxes – as IXCs are prohibited from reflecting variations in exchange access costs – would only cause more troubles for the airlines and cause subsidies between unrelated passengers, the way that the FCC's policies are causing subsidies between unrelated users of the IXCs long distance services and the CLECs customers.

averaging. In any event, IXCs are well positioned to spread variations in costs across their customer base, which is a better solution than requiring CLECs to simply forfeit recovery of legitimately incurred costs associated with exchange access services.

ii. CLECs Should Not Be Required to Shoulder the Burden of Rate Averaging and USF Policies

The distortions associated with prohibitions on de-averaging were recognized by the FCC when it noted:

Not only does the calling party not choose the terminating LEC, but section 254(g) requires IXCs to spread the cost of terminating access rates among all of its end users.⁵³

The FCC failed to recognize, however, that to the extent averaging rules serve universal service objectives, the burden of these policies should be shared by *all* carriers and not be placed on the shoulders of the CLECs and their end-users by preventing recovery of economic costs for providing exchange access. By imposing below-cost exchange access rates on CLECs, regulators force CLECs and their end users to subsidize the IXCs and their customers, including such IXC customers as telemarketers. It should also be recognized that this type of a subsidization scheme – in the name of universal service (i.e., deaveraged long distance rates) – runs contrary to the expressed objectives of the Telecom Act, which mandates that universal service policies be pursued through explicit, not implicit, subsidies.

The FCC is currently reviewing its universal service policies in an attempt to allow the market the flexibility it needs to work effectively. Yet, there is no mention in the FCC's orders of removing regulations that impair the ability of the market to generate proper price signals for exchange access services. CLECs should not be required to provide implicit subsidies for universal service policies, which is precisely what occurs when CLECs are forced to artificially cap their exchange access rates at a level below cost due in part to the prohibition on deaveraging under section 254(g).

IV. MANDATORY BENCHMARKS SERVE TO ACCOMMODATE THE IXCs'/LARGE ILECS' MARKETING STRATEGIES AND CAUSE CROSS-SUBSIDIES AND OTHER MARKET DISTORTIONS

Intrusive mandatory benchmarks for CLECs will facilitate the marketing strategies of the IXCs/Large ILECs at the expense of the public interest.

⁵³ CLEC Access Reform Order, ¶ 11.

A. The FCC's Benchmarking Policy Accommodates the IXC's Marketing Preferences at the Expense of Rate Payers

Both interstate and intrastate toll prices have demonstrated a well-established downward trend over the better part of the last three decades. However, there are indications that this downward trend is being reversed and that toll prices are increasing after many year-after-year decreases. The FCC's most recent Reference Book on rates for telecommunications services shows intrastate toll and interstate toll prices increasing in 2006 (the most recent year available in the 2007 publication) after almost a decade of year-after-year decreases.⁵⁴ Perhaps more importantly, these increases in toll prices roughly correspond to the time at which the mega-mergers of AT&T/SBC,⁵⁵ MCI/Verizon,⁵⁶ and Sprint/Nextel⁵⁷ occurred. While one year of price data may be insufficient to draw definitive conclusions about the extent to which the recent reversal in the established trend of decreasing toll prices is linked to increased consolidation in telecommunications markets, it should be sufficient reason to give regulators pause. At the very least, it should signal to regulators that any examination focusing on exchange access rates of CLECs is too narrow and that any such examination should be expanded to look at the prices of toll services which use exchange access as an input.

This shows that regulators cannot assume, as the FCC did, that reductions in CLEC access charges will be passed through by IXCs via lower long distance rates. Rather, it is quite possible (if not probable) that money taken from CLECs – *by reducing their exchange access rates to below cost levels* – will go directly toward increasing the bottom line of the world's largest, vertically-integrated telecom providers.

B. The FCC's Benchmarking Policies Introduce Unwarranted Price Distortions and Cross-Subsidies

In its CLEC Access Reform Order, the FCC identified its policy objectives:

Some of the overarching goals the Commission has pursued in this effort include the promotion of competition, aligning access rate structures more closely with the manner in which costs are incurred, the removal of subsidies from access rates and deregulation as competition develops.⁵⁸

⁵⁴ Nine years of decreases for interstate toll and eight years of decreases for intrastate toll. FCC 2007 Reference Book on Rates Table 3.1. Inflation Adjusted Interstate Toll Calls and Intrastate Toll Calls.

⁵⁵ The SBC/AT&T merger was announced on or about January 30, 2005 and the FCC order approving the merger was released on November 17, 2005.

⁵⁶ The Verizon/MCI merger was announced on or about February 14, 2005 and the FCC order approving the merger was released on November 17, 2005.

⁵⁷ The Sprint/Nextel merger was announced on December 15, 2004 and the FCC order approving the merger as released on August 8, 2005.

⁵⁸ *CLEC Access Reform Order*, ¶ 8.

Oddly, the FCC's benchmarking policies are inconsistent with these stated objectives.

The FCC itself recognizes that its benchmarking policy places CLECs in a bind because the incumbent LECs' exchange access rates will most likely not permit the CLECs to recover their higher costs in the provision of exchange access services. The FCC notes:

We acknowledged that CLEC access rates may, in fact, be higher due to the CLECs' high start-up costs for building new networks, their small geographical service areas, and the limited number of subscribers over which CLECs can distribute costs.⁵⁹

In contrast to the concerns the FCC expresses about the IXC's costs, the FCC is remarkably cavalier about the problems that under-recovery of exchange access costs creates for CLECs. The FCC offers CLECs two alternatives:

1. "Above the benchmark, CLEC access services will be mandatorily detariffed, so CLECs must negotiate higher rates with the IXCs."⁶⁰
2. Naturally, the CLECs also retain the option of recovering from their end users any additional costs that they may experience.⁶¹

Both of these "options" – negotiating higher rates with IXCs or recovery from end users – are unreasonable, and, in fact, no options at all.

i. The FCC Is Forcing CLEC Customers to Subsidize the IXCs' Customers

Noting that it will refrain from regulating the CLECs' end user rates, the FCC notes:

Naturally, the CLECs also retain the option of recovering from their end users any additional costs that they may experience.⁶²

That this option is tantamount to the creation of a cross-subsidy scheme is most clearly seen with respect to terminating exchange traffic. The cost causers of any cost associated with terminating exchange access are the IXCs' customers. To be sure, it is the IXCs' customers that decide to place calls to the CLECs' end users, and as such, they are the cost causers. Thus, the FCC's recommendation that CLECs recoup any under-recovery of costs from their end users is tantamount to the FCC endorsing a cross-subsidization scheme. While this type of a cross-subsidization scheme runs contrary to the provisions of the Telecom Act, it is most troublesome with respect to unwanted calls from, for

⁵⁹ CLEC Access Reform Order, ¶ 18.

⁶⁰ CLEC Access Reform Order, ¶ 3.

⁶¹ CLEC Access Reform Order, ¶ 4.

⁶² CLEC Access Reform Order, ¶ 4.

example, telemarketers: *why should the CLECs end users be required to subsidize the IXCs' telemarketing customers*⁶³?

ii. Benchmarking Strengthens the IXCs' Near Monopsony Power and Further Distorts the Telecommunications Markets

Economists define markets wherein a single or dominant buyer can effectively set prices as “monopsonistic” or “oligopsonistic.”⁶⁴ Similar to the more commonly understood circumstance of “monopoly” wherein a single *seller* can set prices and influence production levels because it controls all supply components, monopsonistic markets are dominated by enormous *buyers* who so dominate the total demand characteristics of the market, that individual sellers have little choice but to accept prices and/or terms dictated by those buyers.

Taken as a group, Verizon Business (formerly MCI), Sprint, Qwest and AT&T can represent more than 80% to 90% of all switched access minutes sold by a CLEC. Said another way, 80% to 90% of all long distance calls being received by CLEC customers are often carried to the CLECs' networks by those four carriers. This simple fact dominates the way in which rates for exchange access charges are effectively set in the marketplace. While the FCC's *CLEC Access Reform Order* suggests that CLECs may negotiate higher rates than the rates it benchmarked to incumbent levels, that notion is a fallacy. CLECs have little, if any, negotiating strength given they cannot realistically participate in the “self-help” necessary to disconnect these four carriers for non-payment, given that disconnection would keep 80% to 90% of all toll calls from reaching local exchange customers who rely upon the CLECs as their primary telecommunications provider. This places CLECs “between a rock and a hard place.” They must either allow the IXCs to dictate the rates they will pay to the CLECs for exchange access services (and the terms by which they will pay) or substantially inconvenience their own customers by disconnecting the toll carriers that carry a majority of toll calls to those customers (an action that would undoubtedly cause customers to leave in droves). Further, by establishing a benchmark rate no greater than the rate charged by incumbents, the FCC effectively removed any incentive an IXC might otherwise have had to discuss

⁶³ The FCC's No-Call List has substantially cut down on undesirable telemarketing calls; still, telemarketing is a \$15 Billion a year industry. Further, while there is nothing wrong with telemarketing per se, there is no valid public policy justification for artificially subsidizing telemarketers, as would be the case under benchmarking.

⁶⁴ See *Oligopsony* (n), the market condition that exists when there are few buyers, as a result of which they can greatly influence price and other market factors. [www.dictionary.com], likewise; *Monopsony* (n) A market dominated by a single buyer. A monopsonist has the market power to set the price of whatever it is buying (from raw materials to labour). Under perfect competition, by contrast, no individual buyer is big enough to affect the market price of anything. [www.economist.com]

rates that are higher and/or more compensatory because the IXC knows that even if a separate agreement can't be reached, the most it will pay are the benchmarked rates.

The large IXCs expand this relative advantage they enjoy in interstate ratemaking to intrastate ratemaking as well. There is little doubt that AT&T and Verizon Business (MCI) exert oligopsonistic influence in the market for intrastate exchange access. Consider the following scenario that has played out countless times in the past 2-3 years. First, the large IXC simply stops paying the CLEC's intrastate tariffed rate and informs the CLEC that it believes the switched access rate is too high – even if the rates have been tariffed and approved by the relevant state utility commission. Given that one of these carriers may by itself represent 40% to 60% of the CLEC's total switched access revenue, unpaid invoices stack up quickly, resulting in a large unpaid balance and a significant drain on the CLEC's cash flow necessary for operations. Several months may pass as the CLEC weighs its options and undertakes the cost-benefit analysis related to multiple complaints, bristling all the while at its complete inability to exercise self-help in the form of disconnecting its delinquent switched access customer.

Further, AT&T and Verizon are using their monopsony power *to keep CLECs from lowering their cost structures related to exchange access*. Pressure brought to bear by the marketplace on existing cost-structures and resulting prices often comes in the form of technological innovation. As a competing carrier employs more efficient technologies, it is able to maintain acceptable margins at lower rates, thereby driving all other market participants toward market-clearing price levels (and spurring broader adoption of new technology as a result). However, existing technological restrictions placed upon CLECs by the same companies demanding lower switched access rates prohibit the robust deployment of technologies that could help achieve, at least in part, the very result they ask regulators to mandate (*i.e.*, lower switched access prices). For example, AT&T, Qwest and Verizon have both prohibited competitive carriers from interconnecting with their networks for the passage of local or long distance traffic using Internet Protocol (“IP”) based signaling. Carriers like Cbeyond who pride themselves on an IP-centric business model are forced to convert traffic to older Time Division Multiplexed (“TDM” or “circuit switched”) technology before accepting traffic from or delivering traffic, including switched access traffic, to these carriers. These conversions are expensive and inefficient and thereby drive prices for inter-carrier connectivity higher than they have to be. As such, the large ILECs, by arguing for exchange access rates that ignore the CLECs' costs of providing the service, are essentially asking regulators to shield them from higher costs they are instrumental in creating.

Likewise, the rates extracted by the larger IXCs are, in many circumstances, demonstrably below the costs incurred by the CLEC in providing the switched access services in question. As such, CLECs are required to subsidize exchange access rates with revenues generated either from its own local customers or from the smaller IXCs – ultimately harming the CLECs' relative strength in the retail marketplace against other local carriers, including those local carriers affiliated with the largest IXCs (each of which has a CLEC of its own).

Addressing the CLECs' difficulties in collecting exchange access revenues from large IXCs, the FCC found that the CLECs' exchange access rates may be tariffed as long as they are at or below the incumbent LECs' exchange access rates. To the extent, however, that CLECs require higher exchange access rates, the FCC found the following:

Above the benchmark, CLEC access services will be mandatorily detariffed, so CLECs must negotiate higher rates with the IXCs.⁶⁵

This policy fails to recognize the imbalances in the negotiating powers of the CLECs and their largest exchange access customers, such as AT&T and Verizon. As described above, the FCC's provision to permit CLECs to negotiate higher rates with IXCs is a token option. As a practical matter, the FCC has left the CLECs at the mercy of the monopsony powers of the large IXCs and they will rarely if ever be able to negotiate rates higher than the benchmarks.

It is interesting to compare the scenario above with a similar situation wherein the tables are turned. Consider a scenario wherein CLECs attempt to withhold payments for special access services procured from the large ILECs (the parent companies of the large IXCs), simply because they do not like the prices. Obviously, the ILECs would (and have) disconnected the special access circuits for non-payment. There is likely no discernable decrease in the quality of service experienced by the ILEC's own customers because of its effort to disconnect the CLEC, yet disconnection for the CLEC can be devastating. Unfortunately, the same "self-help" option is not available to CLECs when the large IXCs (in most cases affiliated brethren of the same ILECs) fail to pay. CLECs cannot effectively thwart the largest IXCs' self-help efforts in this regard without disconnecting the long distance lifelines of their own local exchange consumers, thereby creating an enormous marketing opportunity for the very carriers exercising self-help (i.e., the IXCs and their affiliated local service providers).

In sum, it is important to note that a monopsony can be as detrimental to properly functioning markets as a monopoly.

V. ILEC EXCHANGE ACCESS RATES ARE COMPANY SPECIFIC AND SHOULD NOT BE USED AS PROXIES FOR CLECS

ILEC exchange access rates have been established as part of large negotiated package deals between the ILECs and various interest groups and involved many quid pro quos. To pick one element out of those deals – exchange access rates – and to apply them to

⁶⁵ CLEC Access Reform Order at 3.

CLECs, who do not benefit from the quid pro quos, is arbitrary and bad public policy.

A. ILEC Interstate and Intrastate Exchange Access Rates Are Set As Negotiated Deals with Quid Pro Quos That Do Not Relate to CLECs

Neither the ILECs' intrastate exchange access rates nor their interstate exchange access rates are reasonable proxies for CLEC exchange access rates. Access charges have historically been set for ILECs based on overall revenue and cost targets that were determined as part of a jurisdictional cost allocation process – a methodology that is arcane and inconsistent with cost causation principles and have no bearing on CLEC operations. Further, both the ILECs' interstate and intrastate exchange access rates were typically set in the context of negotiated deals that reconciled a large number of often unrelated issues for ILECs, regulators, and other interested parties. To lift exchange access rates out of this larger context and apply them to CLECs – without any of the *quid pro quos* extracted by the ILECs – is unfair and unreasonable.

i. Interstate Exchange Access Rates Are Negotiated and Relevant Only to the ILEC for which They Were Set

The following statement by the FCC on the complex processes for setting exchange access rates for ILECs underscores why these rates are not appropriate for CLECs:

The [FCC] uses a multi-step process to identify the cost of providing access service. First, the rules require an incumbent LEC to record all of its expenses, investments, and revenues in accordance with accounting rules set forth in our regulations. Second, the rules divide these costs between those associated with regulated telecommunications services and those associated with non-regulated activities. Third, the separations rules determine the *fraction* of the incumbent LEC's regulated expenses and investment that should be *allocated* to the interstate jurisdiction. After the total amount of interstate cost is identified, the access charge rules translate these interstate costs into charges for the specific interstate access services and rate elements. Part 69 specifies in detail the rate structure for recovering those costs. That is, the rules tell the incumbent LECs the precise manner in which they may assess charges on interexchange carriers and end users.⁶⁶

⁶⁶ *In the Matter of Access Charge Reform*, First Report and Order, 12 FCC Red 15982, 15991-92, at ¶ 22 (1997) (“*Access Charge Reform Order (1997)*”), *aff'd Southwestern Bell Tel. Co. v. FCC*, 153 F.3d 523 (8th Cir. 1998). (emphasis added).

The above FCC description of how access charges have historically been set for ILECs demonstrates two things:

- a) ILEC costs were determined only in some general, top-down⁶⁷ sense and then allocated across various “buckets,” such as regulated vs. non-regulated, state vs. interstate, etc., and
- b) rates were set to recover some general revenue/cost target but were not based on the per unit⁶⁸ costs, such as determined under, for example, TELRIC, or other forms of forward-looking cost studies.

Of course, CLECs have never been a part of this complicated process because it has no relevance to the competitive marketplace in which CLECs operate. CLECs do not separate their costs into regulated and non-regulated activities and services; likewise, they do not engage in jurisdictional separations and allocations of costs between state and interstate jurisdictions. Further, while this top-down cost allocation process may result in rates that permit ILECs to achieve an *overall recovery* of revenue/cost targets, there is simply nothing in this process that ensures that the resulting rates for individual services, such as the various individual components of the switched access services, are in any way cost-based for the ILECs, let alone that they are compensatory or otherwise relevant to the CLECs’ costs and operations.

The negotiated nature of interstate exchange access rates is uncontroverted. On May 31, 2000 the FCC adopted an “integrated interstate access reform and universal service proposal” put forward by AT&T, Bell Atlantic, GTE, SBC and Sprint (referred to by the FCC as the Coalition for Affordable Local and Long Distance Service – CALLS).⁶⁹ The *CALLS Order* substantially altered interstate switched access rates, reducing the rates for SBC and BellSouth (both now AT&T) as well as Bell Atlantic and GTE (both now Verizon) dramatically from previous levels. The primary focus of the order was to reduce interstate access rates paid by CALLS’ long distance members AT&T (before its merger with SBC Communications) and Sprint, while at the same time allowing CALLS’ local exchange members (AT&T and Verizon) to recover those same monies through the interstate universal service support mechanism (*i.e.*, largely a revenue neutral undertaking

⁶⁷ The term “top down” refers to a costing methodology that starts with costs recorded on the company’s books and allocates them – top down – over the company’s services. By contrast, a bottom up approach starts with a company’s telecommunications technologies and network, identifies which technologies and portions of the network are used for certain services, and then proceeds to calculate – bottom up – what the costs are associated with these technologies and portions of the network to arrive at the cost of providing the services. As is generally recognized, the two methodologies may not result in the same service costs or in the same overall costs.

⁶⁸ The term “per unit costs” refers to the costs calculated for one unit of a service, such as a minute of use. Costs calculated under either the FCC’s TELRIC methodology, or the Commission’s Subst R. § 26.215 (LRIC methodology), are calculated on a per unit cost basis.

⁶⁹ *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, FCC 00-193, Adopted May 31, 2000 (hereafter “*CALLS Order*”).

for the ILECs).⁷⁰ Even a cursory reading of the order indicates that the CALLS proposal adopted by the FCC was a landmark event in the process of interstate access reform, and that the reduction in switched access rates offered by the local exchange carriers was an integral part of the “agreement” reached.

It is important to note that the exchange access rates produced by the *CALLS Order* were set primarily through a *negotiated* agreement reached by the ILECs and IXC. The behind the scenes negotiations establishing the *CALLS Order* and the resulting rates are revealed in an illuminating dissent by FCC Commissioner Harold Furchtgott-Roth.⁷¹ In his dissent, Commissioner Furchtgott-Roth provides a rare look “behind the curtain” of the process leading up to the *CALLS Order* and offers some enlightening insights. He begins his dissent by agreeing that interstate access charges (at that time) bore *little resemblance to the “costs of access actually incurred.”* He then goes on to discredit the process by which the lowered rates were reached as “dismaying.” Indeed, he expressed his opinion that “the process by which the original CALLS proposal was modified [and ultimately approved] is fundamentally inconsistent with principles of neutrality and transparency that must govern agency decision making.”

Specifically, the Furchtgott-Roth Dissent describes a process whereby the CALLS organization (primarily the remaining AT&T, Verizon and Sprint) negotiated with various consumer groups in an effort to craft a modified proposal regarding reduced switched access rates and increased universal service fund monies that would be adopted by the FCC. Commissioner Furchtgott-Roth reveals three important aspects of this process:

- a) The Commission (acting chiefly through the Common Carrier Bureau) apparently “refereed” the negotiations between the parties, and participated in recommending various outcomes negotiated by the parties (*i.e.*, the Common Carrier Bureau apparently agreed to recommend to the Commission for approval, certain components of the parties agreement(s)). Commissioner Furchtgott-Roth complained that the FCC, in playing the dual role of referee and decision maker, had acted in a highly improper manner.
- b) Several key participants who were interested in the process were denied access to the negotiations which ultimately resulted in the settlement agreement adopted by the FCC, *i.e.*, the Ad Hoc Telecommunications Users Committee, Time Warner Telecom, and the Association for Local Telecommunications Services (basically competitive local exchange carriers),⁷² and

⁷⁰ *CALLS Order*, ¶ 3.

⁷¹ *Statement of Commissioner Harold Furchtgott-Roth, Concurring in Part and Dissenting in Part*, appended to the *CALLS Order*, May 21, 2000 (hereafter “*Furchtgott-Roth Dissent*”).

⁷² In essence, it appears that the ILECs’ primary local exchange competitors were barred from the discussions, even though they would have had a direct interest in the resultant switched access rate levels. This is especially true because approximately one year later, the FCC required that these same competitors

- c) Concessions regarding access rate levels were gained from the ILECs by the FCC's agreement to make decisions in the ILECs' favor regarding not only additional universal service funds, but also two other actions completely independent from switched access services (*i.e.*, decisions regarding their obligations to provide Enhanced Extended Links – "EELs" – to competing local service providers and an ongoing audit initiative related to continuing property records). As Commissioner Furchtgott-Roth put it: "[I]t was entirely improper for the Commission to have permitted the unrelated matters of depreciation and special access [sic] become part of the negotiations."

In other words, the ILEC exchange access rates resulting from the CALLS negotiations, and which serve as the baseline for CLEC interstate exchange access rates due to the FCC's benchmarking policy, were not adopted based upon a diligent review of economic variables or even an attempt to arrive at a more efficient or competitive switched access marketplace. Instead, they were established as a negotiated settlement meant to appease multiple participating parties who had been allowed the benefit of participating, each with its own regulatory wish list including many objectives having nothing to do with switched access. Importantly, CLECs, whose interstate exchange access rates are capped at the rate level produced by the CALLS process, were specifically precluded from participating in the process.

The manner in which ILEC interstate access rates were established at the FCC is too often overlooked when examining the issue of benchmarking CLEC rates to those of the ILECs. The advocates of benchmarking (or capping) CLEC exchange access rates bypass this important issue and simply assume that the ILEC rates somehow "make sense," or that they are the result of reasoned and rational policy-making. Nothing could be further from the truth. The interstate access rates set for carriers like SBC and Verizon were established through regulatory "give and take" aimed at appeasing the carriers fortunate enough to have been involved in the negotiations. This included promises to SBC and Verizon that the revenues they were giving up would be made up with monies from the universal service fund, promises that the FCC would end an ongoing audit that had (on a preliminary basis) shown an embarrassing shortfall in the plant accounts of the major ILECs related to continuing property records supporting their interstate rate-base, and promises that the FCC would raise the barriers for competitors making use of SBC and Verizon unbundled network element ("UNE") combinations – EELs – to compete for local exchange customers. In other words, SBC and Verizon received a good deal of consideration (*i.e.*, money) for their agreement to lower their interstate switched access rates – consideration that CLECs were not afforded, even though they were required by the FCC to mirror these same concessionary interstate access rates approximately one year later.

charge exchange access rates no higher than the incumbent LECs, rates which resulted from the CALLS discussions.

ii. ILEC Intrastate and Interstate Exchange Access Rates Are Complementary and Related Like Yin and Yang

As the FCC's *Access Charge Reform Order* illustrates, interstate and intrastate access revenues and cost targets are like Yin and Yang – together they make up the whole, and whatever is missing or eliminated from one jurisdiction tends to pop up in the other as costs to be recovered. It is for this reason, among others, that the determination of jurisdictional separations procedures involves not just the FCC, but also the Federal-State Joint Boards that provide essential input into the deliberations and are more explicitly concerned with the states' interests.

The following FCC discussion further illustrates the historic complexities of setting intrastate and interstate access charges that are inherently linked; it also illustrates that these rates are specific to individual companies and should not be arbitrarily applied to other, very differently situated companies, such as CLECs, who are not part of nor privy to the negotiations in this process. The FCC notes:

Determining the costs that an incumbent LEC incurs to provide interstate access services and that, consequently, should be recovered from those services, is relatively straightforward in some cases and problematic in others. Some facilities, such as private lines, can be used exclusively for interstate services and, in such cases, the entire cost of those facilities is assigned to the interstate jurisdiction by the separations rules. *Most facilities, however, are used for both intrastate and interstate services.* The costs of some of these facilities vary depending on the amount of telecommunications traffic that they handle. The separations rules typically assign these traffic-sensitive (TS) costs *on the basis of the relative interstate and intrastate usage of the facilities*, as measured, for example, by the relative minutes of interstate and intrastate traffic carried by such facilities. By contrast, the costs of other facilities used for both interstate and intrastate traffic do not vary with the amount of traffic carried over the facilities, *i.e.*, the costs are non-traffic-sensitive. These costs pose particularly difficult problems for the separations process: *The costs of such facilities cannot be allocated on the basis of cost-causation principles because all of the facilities would be required even if they were used only to provide local service or only to provide interstate access services.* A significant illustration of this problem is allocating the *cost of the local loop, which is needed both to provide local telephone service as well as to originate and terminate long-distance calls.* The current separations rules allocate 25 percent of the cost of the local loop to the interstate jurisdiction for recovery through interstate charges.⁷³

⁷³ *Access Charge Reform Order (2001)*, ¶ 23.

The above FCC discussion underscores the essential point that the jurisdictional allocation of costs, particularly where it concerns usage based allocators, impacts *both* interstate and intrastate access rates.

iii. Intrastate Exchange Access Charges Are Also Negotiated and Relevant Only to the ILEC for which They Were Set

While the federal process for setting exchange access rates is far from transparent, state processes for setting intrastate rates may be even murkier. Intrastate access rates for ILECs are typically set in the larger context of alternative regulation plans involving trade-offs between access rates and other provisions negotiated between the ILEC and interested parties permitted to participate. Consequently, few if any ILECs have access rates based on forward-looking economic costs.

Underlying the benchmarking/capping proposals at the state levels is the contention that CLECs should make further concessions by adopting intrastate exchange access rates benchmarked to the ILECs rates (again without the quid-pro-quo of revenue enhancement or cost reductions, and nothing like the federal universal service fund support promised to ILECs in the *CALLS Order*), even when, as discussed below, it is clear such rates are well below the CLECs' costs of providing service.

In any event, given that the ILECs' exchange access rates have no merit *outside the overall context of their own specific and individual regulatory regimes*, those rates could not possibly be just and reasonable for CLECs.

B. ILEC Exchange Access Rates Are Not a Valid Proxy for Competitive Market Rates

Advocates of benchmarking have argued that, if markets were competitive, then CLECs would have to meet the market price for exchange access services, which, according to them, would be the ILECs' exchange access rates. This argument is wrong for a number of reasons.

i. ILEC Exchange Access Rates Are Not Uniform – there Is No Semblance of a Competitive Level

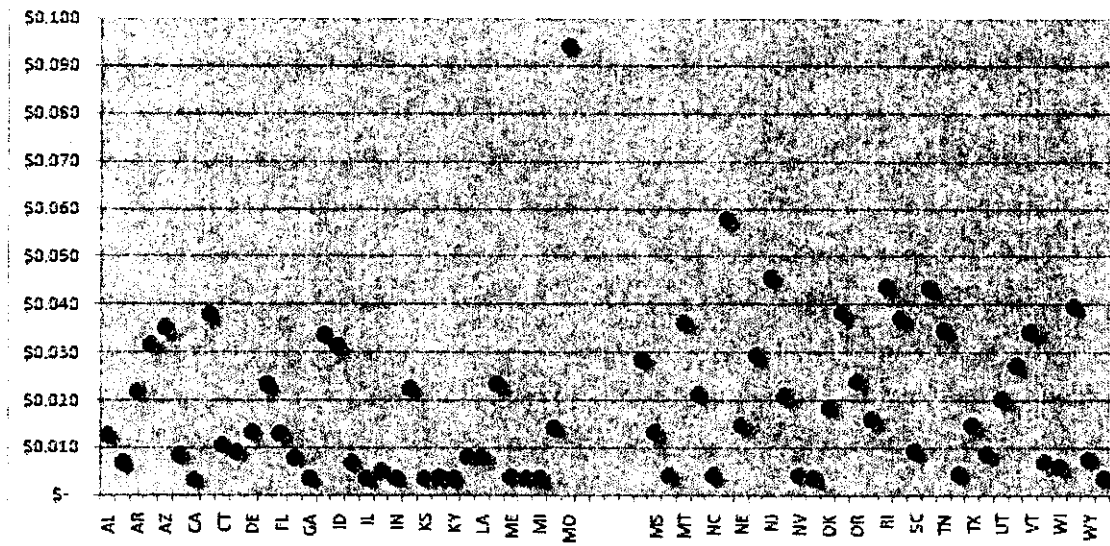
An examination of the ILECs' intrastate exchange access rates shows that there is an enormous degree of variation from company to company and state to state. (See diagrams below.) This degree of variation is at odds with any notion that the ILECs' exchange access rates are reasonable surrogates or proxies for a competitive market rate. There is no uniformity – in fact, there is a hodge-podge, reflecting the previously discussed

wheeling and dealing involved in exchange access rate setting. To hold these rates up as representing “competitive market levels” is misguided.

QSI’s survey pulled together switched access rates of the three large ILECs (AT&T, Verizon and Qwest) and their affiliate CLECs⁷⁴ and calculated the composite per minute access rates – the aggregated rates that permit comparisons between carriers.⁷⁵

The charts and tables below summarize the results of the access rate survey. They depict the intrastate and interstate access charges and their variations, underscoring the fact that there is no single “universal” or “uniform” level of access charges.

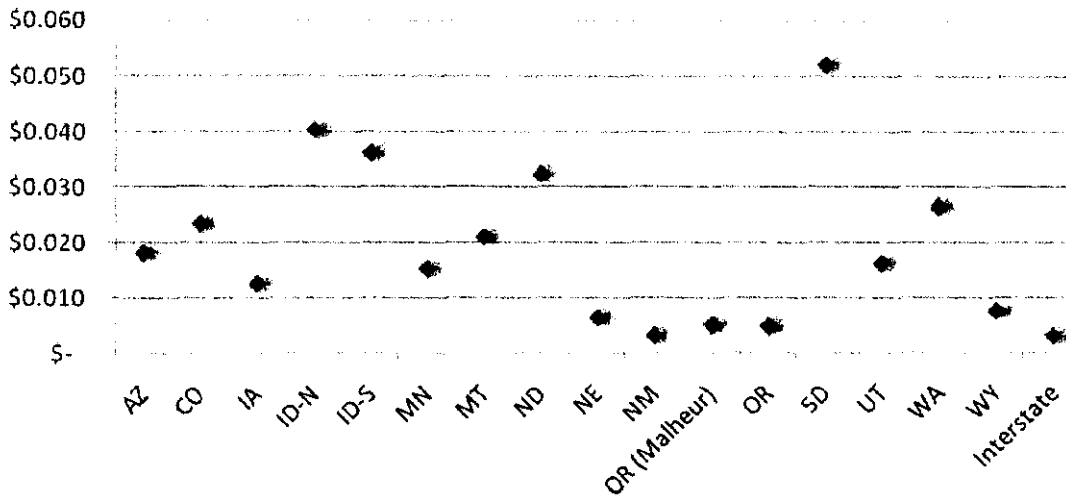
**AT&T Composite Intrastate Access Rates per AMOU
(One-Sided)**



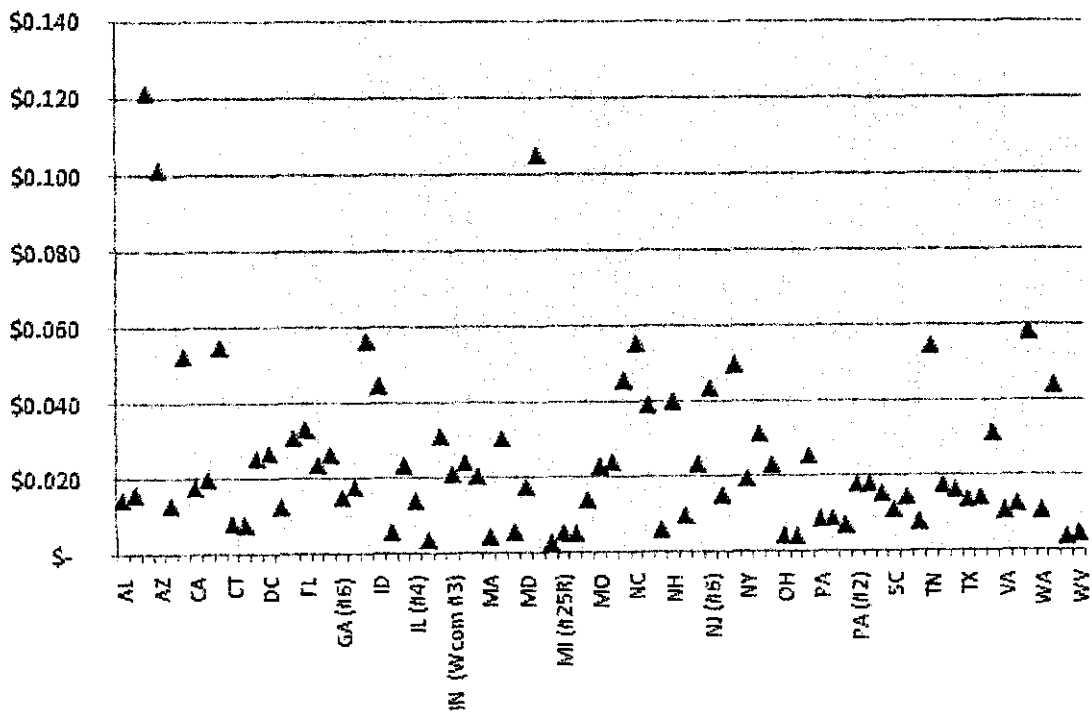
⁷⁴ The starting point of QSI’s survey an access rate database obtained from Telview.

⁷⁵ The composite rates presented below are rates per access minute of use (one side of a long-distance call). They were calculated based on a scenario that a call is routed via tandem transport with transport mileage of 10 miles. Because this survey was part of the broader study of access rates across company types (RBOCs, mid-sized ILECs, small ILECs and CLECs) and because smaller companies often do not own a tandem, the tandem switching rates are not included in the calculation of the composite rates in order to make an apples-to-apples comparison. In cases where rates were zoned or differentiated according to direction or time of day, a straight average of the differentiated values was used.

QWEST Composite Intrastate Access Rates per AMOU (One-Sided)



VERIZON Composite Intrastate Access Rates per AMOU (One-Sided)



Clearly, the “competitive rate level” for exchange access services sought by advocates of benchmarking policies does not exist with respect to large ILECs exchange access rates. Therefore, to require CLECs to benchmark their rates against the hodge-podge of ILEC rates would not bring the industry any closer to “competitive” exchange access rates; rather it would simply require CLECs to mirror the same hodgepodge that exists today without any discernable benefit.

ii. CLECs Are Not In a Position to Reject IXC Traffic

Those who advocate benchmarking policies based on the notion that competitive markets impose uniform price levels also overlook that CLECs are *obligated* to accommodate the IXCs’ exchange access traffic.⁷⁶ In competitive markets, companies generally have the option to scale back their sales and market share when price is not compensatory, which is not the case for CLECs in exchange access markets. CLECs have no choice but to accommodate the IXCs’ exchange access traffic – whether or not the CLEC is being fairly compensated. Of course, CLECs can scale back their overall presence in an ILEC’s territory, in which case they would not need to accommodate as much IXC traffic. However, this dynamic gives the large ILECs that have long distance affiliates (such as AT&T and Verizon) control over their retail competitors, the CLECs, by leveraging their monopsony power in wholesale markets. That is, by withholding payments for wholesale exchange access traffic, companies such as AT&T and Verizon are able to handicap CLECs in their ability to compete in retail markets. This corrosive dynamic, which is reinforced with benchmarking policies, undermines the retail competition that public policy has sought to foster since the passage of Telecom Act.

In any event, it is inconsistent to require benchmarking of CLEC exchange access rates based on the notion that it emulates a competitive market – i.e., *meet the market price or leave* – while at the same time obligating CLECs to accommodate the IXCs’ traffic, irrespective of whether prices are compensatory.

**VI. WHOLESALE RATES SHOULD BE COMPENSATORY:
CLECS AND LARGE ILECS ARE DIFFERENTLY SITUATED
AND HAVE DIFFERENT WHOLESALE COSTS**

A one-size-fits-all approach inherent in benchmarking policies is inconsistent with standing regulatory policies that consider individual company costs in

⁷⁶ Irrespective of whether a CLEC has a legal obligation to terminate or originate long distance traffic on behalf of IXCs, here our concern is the real-world option of CLECs to reject IXC traffic – an option that does not exist, especially with respect to the largest IXCs. No CLEC could compete effectively if its end users were unable to receive calls from the nations’ largest IXCs – indeed, anywhere from 60% to 80% of all calls to the CLEC’s end users would not be completed.

setting wholesale rates: switched access rates vary from state to state and from company to company, and so do wholesale UNE rates. In the event it is determined that regulatory intervention is needed to cap CLEC access rates, wholesale rates should be set based on considerations of individual company costs not on some arbitrary benchmark. Capping CLEC exchange access rates at levels set for the world's largest, vertically and horizontally integrated ILECs is unfair and bad public policy.

A. The Touchstone for Just and Reasonable Rates is Cost

It is standard practice in public utility regulation to either explicitly or implicitly examine rate-setting practices against the backdrop of the regulated firm's costs. This is true whether the discussion concerns traditional rate of return regulation or other forms of regulation. As the United Supreme Court noted:

The enduring feature of ratesetting from *Smyth v. Ames* to the institution of price caps was the idea that calculating a rate base and then allowing a fair rate of return on it was a sensible way to identify a range of rates that would be just and reasonable to investors and ratepayers.⁷⁷

When rates are set below costs, it may lead to under-recovery and cross-subsidies or constitute such anti-competitive practices as predation. When rates are set too high, it may lead to over-recovery of costs and represent an exercise of market power. Generally, economists advocate that rates be set at costs to provide the appropriate price signals and to prevent other distortions. The rare exception to this rule is when regulators have other pressing public policy concerns, such as the pursuit of universal service.⁷⁸

For the better part of the twentieth century, much of public utility regulation, and certainly the regulation of telecommunications utilities, involved traditional rate-base/cost-of-service regulation. While allocations of costs across various customer classes and jurisdictions (such as intrastate and interstate) might have been impacted by universal service policies, the ultimate basis for rates and revenues was costs. Even as telecommunications regulation moved away from traditional rate-base regulation in the latter part of the twentieth century, the FCC continued to emphasize costs as the relevant benchmark for just and reasonable rates. The notion that costs have been and remain the ultimate benchmark for just and reasonable rates is generally recognized and is evinced by such FCC statements as:

⁷⁷ See *Verizon v. FCC*, 535 U.S. at 487-88.

⁷⁸ Prior to the Act, state commissions deliberately set some rates above cost in order to keep rates for basic local telephone service low, particularly in areas such as rural areas where costs are high. The Act eliminated such implicit subsidies and required that the FCC establish an explicit funding mechanism. Some states have established an explicit funding mechanism to support universal service.

The Communications Act requires that rates be just and reasonable and not create unreasonable discrimination or undue preference. Section 201(b) and 202(a), 47 U.S.C. §§ 201(b), 202(a). [...] ***Costs are traditionally and naturally a benchmark for evaluating the reasonableness of rates.***⁷⁹

About a decade later, after the passage of the Telecommunications Act of 1996, the FCC reiterated the identical notion and language:

[C]osts are traditionally and naturally a benchmark for evaluating the reasonableness of rates under Section 201(b) of the Act.⁸⁰

The linkage of costs with just and reasonable rates typically runs through FCC orders involving rate setting issues, particularly where it concerns carriers accessing one another's facilities. For example, in its 1997 *Expanded Interconnection Order*, the FCC, in line with its long standing tradition, again established costs as the appropriate benchmark for just, reasonable and nondiscriminatory rates:

It is clear that the success of efficient competitive entry through interconnection depends on the interconnectors' ability to obtain access to the LEC's transmission facilities ***at rates that reflect costs*** under terms, and conditions that are ***just and reasonable***. Pursuant to sections ***201 through 205*** of the Communications Act of 1934 ... we are using the tariff review process to ensure that LECs provide interstate expanded interconnection service at rates, terms and conditions that are just, reasonable and nondiscriminatory.⁸¹

The FCC's approach is consistent across various arenas of its jurisdiction. For example, in 2004, in evaluating whether rates charged by certain international carriers were "just and reasonable," the FCC again evaluated costs of providing the services:

The Commission determined that ***above-cost settlement rates*** paid by U.S. carriers to terminate international traffic are neither ***just nor reasonable***, and it acted pursuant to its statutory authority in Section 201(b) of the Communications Act to prohibit U.S. carriers from continuing to pay such charges.⁸²

⁷⁹ *Investigation of Special Access Tariffs of Local Exchange Carriers*, Memorandum Opinion and Order, 4 FCC Rcd 4797, 4799, at ¶ 32 (1988) ("*Special Access Tariff Order*"). (emphasis added)

⁸⁰ *In the Matter of INFONXX, Inc., Complainant, v. New York Telephone Co., Defendant*. Memorandum Opinion and Order, 13 FCC Rcd 3589, 3597, at ¶ 15 (1997).

⁸¹ *In the Matter of Local Exchange Carriers' Rates, Terms, and Conditions for Expanded Interconnection Through Physical Collocation for Special Access and Switched Transport*, Second Report and Order, 12 FCC Rcd 18730, 18733, at ¶ 2 (1997) ("*Expanded Interconnection Order*"). (emphasis added)

⁸² *In the Matter of International Settlements Policy Reform International Settlement Rates*, First Report and Order, 19 FCC Rcd 5709, 5742, ¶ 74 (2004). (emphasis added)

In a complaint case in 2001, the FCC also used costs as a benchmark for whether rates were just and reasonable:

In this memorandum Opinion and Order, we examine, as requested by the court, whether or not the billing practices described in Count I of Plaintiffs' Third Amended Complaint are per se unjust and or unreasonable under Section 201(b). The factors we consider include *the relationship of carrier costs to the billing charges* or practices...⁸³

The same is true in yet another complaint proceeding; as the FCC found:

[T]he Commission considers three factors in determining whether a CMRS provider has *violated section 201(b) of the Act*: (1) the relationship of carrier *costs to billing charges or practices*; (2) consumers' expectations based on wireline experience; and (3) the role of the competitive markets. (Emphasis added.)⁸⁴

In sum, the FCC has well established that the term "just and reasonable" is inherently tied to costs.

The FCC has repeatedly referenced standard economic theory concerning the benefits of cost-based pricing policies. Going back almost two decades, a good example of how the FCC explained its cost-based pricing policies is the following:

Costs are traditionally and naturally a benchmark for evaluating the *reasonableness of rates*, because cost based rates both deliver price signals which contribute to efficient use of networks and generally distribute network costs to the customer who causes those costs.⁸⁵

In its *Local Competition Order*, the FCC again cited the signaling function of cost-based prices as the predominant reason for mandating the use of forward-looking incremental costs to set cost-based rates as required by section 252(d)(1) of the Act:

We observed in the NPRM that *economists generally agree* that prices based on forward-looking long-run incremental costs (LRIC) give

⁸³ *In the Matter of Petition for Declaratory Ruling on Issues Contained in Count I of White v. GTE*, Memorandum Opinion and Order, 16 FCC Rcd 11558, 11560, ¶ 8 (2001). (emphasis added)

⁸⁴ *In the Matter of Bruce Gilmore, Claudia McGuire, The Great Frame Up Systems, Inc., and Pesger, Inc., d/b/a The Great Frame Up v. Southwestern Bell Mobile Systems, L.L.C., d/b/a Cingular wireless*, Memorandum Opinion and Order, 20 FCC Rcd 15079, 15083, ¶ 11 (2005). (emphasis added)

⁸⁵ *Special Access Tariff Order*, 4 FCC Rcd at 4799, ¶ 32. (emphasis added)

appropriate signals to producers and consumers and ensure *efficient entry and utilization* of the telecommunications infrastructure.⁸⁶

In short, the FCC has repeatedly recognized standard economic principles in supporting pricing policies that establish rates in close alignment with costs.

B. CLECs Do Not Have the Economies of Scale and Scope of Large ILECs and Will Generally Have Higher Per-Unit Costs

Regulators, such as the FCC, as well as entities such as the Universal Service Administration Company (“USAC”), have repeatedly recognized that CLECs and small ILECs have higher costs than other, larger incumbent carriers. Further, the FCC in its *CLEC Access Reform Order* provided a different standard for rural CLECs, noting that higher costs (in this circumstance as a result of rural subscribership) must be recognized within regulated rates.⁸⁷

However, it is not the “rural” nature of the cost landscape that makes a network intrinsically high-cost; rather, it is the size and density of the network. And, even though many CLECs may operate in densely populated areas, the nature of their new entrant status generally implies that they serve relatively few customers that are geographically dispersed. In this aspect of their operations, they are much like rural carriers.

The relationship between *scale economies and costs* is well-recognized by the FCC:

Fixed costs are the largest portion of the cost of a switch. The average cost of providing service to customers decreases as the number of customers served increases. As a general rule, we find that scale economies are more pronounced when switches operate at full utilization. Because incumbent LEC switches serve the majority of customers for local exchange service, they are likely to be able to take advantage of substantially greater economies of scale than the competitor would using its own switches.⁸⁸

Another instance in which the FCC recognized the relationship between size and costs is the following:

⁸⁶ *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98, First Report and Order, 11 FCC Rcd 15499 (1996), ¶ 360 (“*Local Competition Order*”), aff’d in part and vacated in part sub nom. *Comp. Tel. Assoc. v. FCC*, 117 F.3d 1068 (8th Cir. 1997) and *Iowa Utils. Bd. v. FCC*, 120 F.3d 753 (8th Cir. 1997), aff’d in part and remanded, *AT&T v. Iowa Utils. Bd.*, 525 U.S. 366 (1999); on remand *Iowa Utils. Bd. v. FCC*, 219 F.3d 744 (8th Cir. 2000), reversed in part sub nom. *Verizon Communications, Inc. v. FCC*, 535 U.S. 467 (2002). (emphasis added)

⁸⁷ *CLEC Access Reform Order*, ¶ 65.

⁸⁸ *In the Matter of 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, FCC 99-238, Rel. November 5, 1999, ¶ 258 (“*UNE Remand Order*”).

The Commission has recognized that smaller telephone companies have higher local switching costs than larger incumbent local exchange carriers (ILECs) because the smaller companies cannot take advantage of certain *economies of scale*.⁸⁹ (Emphasis added.)

Elsewhere, the FCC makes similar observations:

We find that incumbent LECs retain material scale advantages with regard to provisioning and operating local circuit switches. Requesting carriers therefore will encounter generally greater direct costs per subscriber when provisioning their own switches, particularly in the early stages of entry when requesting carriers may not have the large number of customers that is necessary to increase their switch utilization rates significantly. *When we examine the market as a whole, we find that requesting carriers incur higher costs due to their inability to realize economies of scale using circuit switching equipment.*⁹⁰

The higher switching costs incurred by CLECs has also been recognized in the universal service support context by the USAC. In specifying conditions for high cost support for competitive companies, the USAC notes:⁹¹

Local Switching Support (LSS) is available to *competitive carriers* providing service in the areas of *rural incumbent carriers* serving 50,000 lines or fewer (mostly rate-of-return and some price-cap carriers) and designated as eligible telecommunications carriers (ETCs) by their state commissions or the Federal Communications Commission (FCC).

[...]

Local Switching Support is designed to help carriers recoup some of the high fixed switching costs of providing service to fewer customers. LSS helps keep customer rates comparable to more densely populated urban areas.

QSI has examined cost studies for the large ILECs in many states and has prepared cost studies for a number of CLECs. While we are generally unable to publicly divulge details of those studies due to confidentially agreements and concerns, we have filed public testimony demonstrating the substantial discrepancies between large ILECs and CLECs. For example, in a Texas proceeding, QSI provided the following:

⁸⁹ *National Exchange Carrier Assn., Inc. proposed Modifications to the 1998-99 Interstate Average Schedule Formulas*, Order, 13 FCC Rcd 24225, at n. 6.

⁹⁰ FCC *UNE Remand Order*, ¶ 260. (emphasis added)

⁹¹ See, USAC website for competitive carriers: <http://www.usac.org/hc/competitive-carriers/step01/local-switching-support.aspx>

It shows that AT&T Texas sells nearly 13 times more switched access minutes in a year than does McLeodUSA [in Texas]. In other words, in terms of the economies of scale between the two carriers related to this product alone, AT&T Texas dwarfs McLeodUSA. [...] It seems clear that if we were to include in the comparison above, the local calls switched by AT&T Texas, compared to the total minutes switched by McLeodUSA, the disparity would be even larger. The sheer overall economies of scale (and scope – i.e. when services other than switched access are considered) make the two companies very poor “comparables” when evaluating their relative costs of producing switch-based services.⁹²

Clearly, smaller carriers, such as CLECs, lack the economies of scale of large ILECs and, therefore, have generally higher per unit switching costs (recall that switching costs are a primary building block of exchange access services). Given that CLECs have higher per unit switching costs than large ILECs, it is unfair and likely confiscatory to cap CLEC exchange access rates at the level charged by large ILECs.

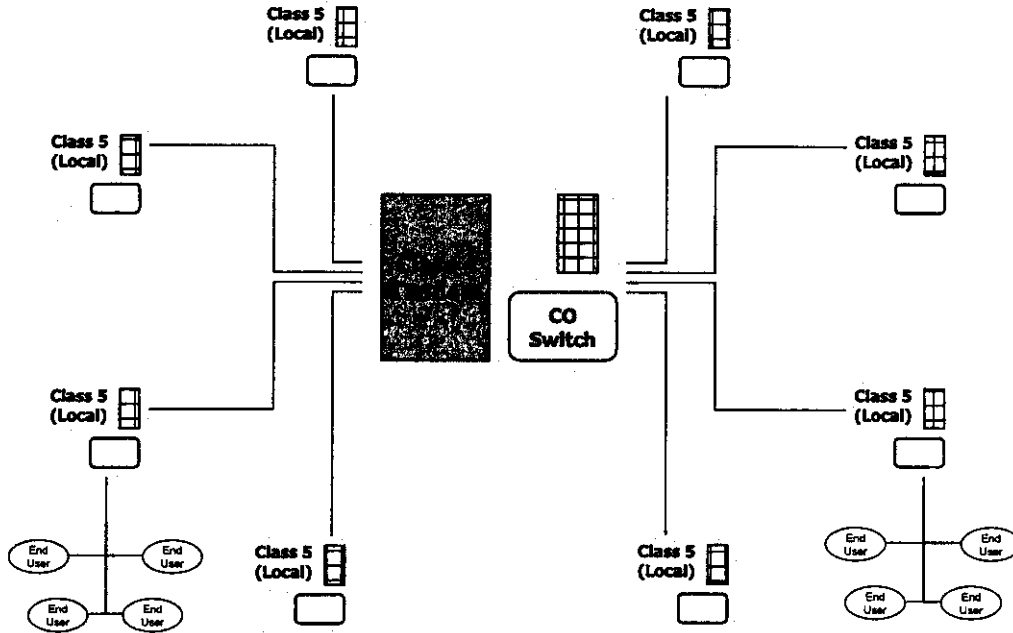
C. CLECs and ILECs Have Different Network Architectures and Thus Different Costs

CLECs typically enter the market with a distributed network architecture that is significantly different from that of the ILECs. Under this distributed architecture, CLECs tend to substitute longer transport routes for switching nodes and outside plant facilities, while at the same time providing origination/termination services throughout large geographic areas roughly comparable in size to areas served, for example, by ILEC tandem switches (which aggregate traffic from the ILEC’s end office switches).

The diagrams below illustrate and compare the two different architectures. The first is the traditional distributed ILEC architecture that uses both Class 5 (end office) and Class 4 (tandem) offices to serve a specific geographic area.

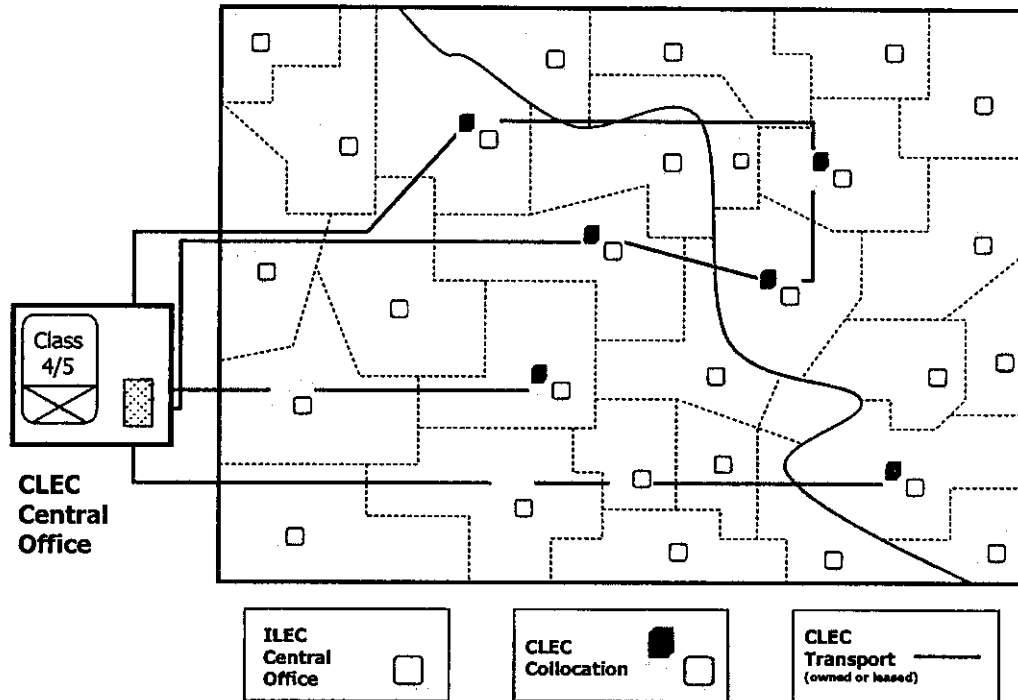
⁹² *Application of McLeodUSA Telecommunications Services, Inc., for Approval of Intrastate Switched Access Rates Pursuant to PURA Section 52.155 and PUC Subst. R. 26.223, SOAH Docket. 473-07-1365, and PUC Docket No. 33545, Rebuttal Testimony of Michael Starkey, page 14.*

ILEC Switch Hierarchy



The second represents a typical CLEC architecture that uses one switch to serve a comparable geographic area. The CLEC uses one switch for the same area as the ILEC because unlike the ILEC who serves the majority of the customers in the serving area, the CLEC can expect to serve only a fraction of all the customers in the area.

Distributed CLEC Network Design



CLECs generally deploy switches that provide a *combined* Class 5 (end office)⁹³ and Class 4 (tandem)⁹⁴ functionality (rather than switches that provide those functionalities on a stand-alone basis) and by means of a distributed architecture provide call origination and termination services across large geographic areas. By extending their switching and transport networks into collocated arrangements in multiple ILEC central offices, CLECs often are able to serve a customer base that is spread out across an entire state or LATA using a single, integrated end office and tandem switching platform.

The cost advantages of this architecture are that it minimizes the amount of switching and central office investment required to serve a more *dispersed customer base*, both by minimizing the number of Class 5 local switches required as well as reducing the need for a stand-alone tandem switch. However, the tradeoff is that this network architecture requires additional investments in transport and collocation. Given that most of the costs of these components are *traffic sensitive* costs, the CLEC network architecture will

⁹³ Class 5 (end office) switches typically aggregate the traffic of end user customers over end user loops, which terminate at the switch. They also provide the vertical features, such as call waiting, etc.

⁹⁴ Class 4 (tandem) switches are typically used to aggregate the traffic from end office switches and provide a point in the ILEC network at which IXCs can connect for terminating and originating long distance calls.

increase the *traffic sensitive costs* of inter-carrier traffic, which should be recognized in exchange access rates.

To properly explain differences in the costs of terminating and originating traffic between large ILECs (e.g., AT&T and Verizon) and CLECs, one should, at a minimum, consider the differences between the ILECs' and the CLECs' network architectures and cost structures. This type of inquiry was not performed by the FCC before establishing the benchmark for CLEC interstate exchange access rates, and any state regulator considering a benchmark for CLEC intrastate exchange access rates should not duplicate this error.

D. CLECs Generally Experience Lower Levels of Utilization for Switching and Transport Facilities

CLECs typically purchase large switches, such as a Lucent 5ESS or Nortel DMS500, capable of serving as many as one hundred thousand customers. Likewise, the SONET facilities constructed to transport traffic to end-users and other carriers are often capable of carrying huge volumes of traffic. Unlike ILECs, even efficient CLECs must deploy these facilities prior to having sufficient numbers of customers to achieve the utilization for which the facilities are designed. This means that, over much of their economic life, the utilization of CLEC facilities is substantially below full capacity, and below the utilization experienced by ILECs.

In contrast, when an ILEC installs or has installed a new digital switch, it does so to replace an old, existing analog switch that is already serving a large number of customers. In fact, old analog switches, such as the 1AESS, may serve tens of thousands of customers that may very well be comparable to the number of customers that a fully loaded digital switch serves (though the analog switch cannot provide the same functionalities). This means that from the moment the ILEC installs a digital switch, it will be able to achieve a higher rate of utilization relative to a new entrant.

The ILEC is also capable of achieving high utilization rates on existing digital switches in wire centers that are experiencing growth. In such situations, the ILEC will often grow the digital switch by installing additional switch modules in the same central office, or it will place remotes that are served by the existing host switch. In either case, the overall level of switch utilization will be high. The same is true for ILEC transport facilities. Here too, ILECs reap the benefit of having a mature network that serves a large, existing customer base so that new facilities can be added incrementally as new demand is anticipated to materialize.

This means that even though a CLEC may employ *optimally efficient*, state-of-the-art facilities, they are likely to experience average utilization rates – over the economic life of the facilities – below those experienced by the larger ILECs. This is an economic fact.

E. CLECs Share More Characteristics with Rural or Mid-tier ILECs than They Do with the Large ILECs

This section demonstrates that CLECs have far more in common with rural or mid-sized ILECs than they do with large ILECs, such as AT&T, Verizon or Qwest. In view of this, comparing CLEC exchange access rates to those of the vertically-integrated large ILECs in an attempt to determine whether CLEC exchange access rates are too high should be a non-starter. If any comparison is to be made to judge the reasonableness of CLEC exchange access rates, it would be more appropriate to compare CLEC rates to those of mid-sized and small ILECs.

i. CLECs Tend to Serve a Sparse Customer Base

By and large, CLECs operate and compete with large ILECs, such as AT&T and Verizon, in urban or suburban environments that are densely populated. However, while a high population density in these areas translates into a dense customer base for the large ILECs, the CLEC customer base is typically far more dispersed.

Once CLECs enter a particular geographic market, they tend to serve customers over an area that is roughly comparable to the local calling areas of the ILEC. However, due to their status as new entrants, among other factors, CLECs will only serve *a fraction* of the customers in these areas. Thus, if a CLEC's customer base is expressed on a customer-per-square mile basis, it is very sparse relative to that of the ILECs that serve the vast majority of customers in the same area.

While the nature of CLECs as new entrants to the market intuitively suggests that their customer density is lower than the customer density of the incumbents, actual empirical evidence is lacking because of the proprietary nature of the CLEC line count data. Although the FCC reports statewide line counts for CLECs and ILECs in its *Local Competition Report*, these data provide information only on the combined line counts of CLECs at a state level and does not indicate customer density for an *individual* CLEC within its serving territory.⁹⁵

QSI obtained permission from several of its CLEC clients to analyze their end user customer line count density data and report the results in aggregate (to preserve the

⁹⁵ Because the combined CLEC line counts and shares reported in the FCC *Local Competition Report* are lower than the ILECs' line counts and shares (and there are a number of CLECs operating in each incumbent's territory), it is clear that the underlying CLEC-specific customer density is significantly less than the customer density of the incumbents in which territories CLECs operate. For example, in its most recent Local Competitions Report (released in December 2007) the FCC reports that the CLEC share is on average 17% nationwide, and the highest CLEC share (46%) is observed in Rhode Island. However, the Rhode Island's relatively high CLEC market share is based on 21 CLECs and one ILEC, meaning that each individual CLEC in Rhode Island is likely much smaller than the ILEC (The market shares in this example are from the FCC *Local Competition Report* released in December 2007, Table 7, and the number of reporting carriers are from Table 13).

anonymity of individual carriers). The basic design of the study was to construct a measure of customer density of an average individual CLEC within its serving territory (where the CLEC serving territory is defined as the ILEC's wire centers in which the CLEC is collocated) and compare it to the customer density of the respective ILEC. This study consisted of the following steps:

1. The starting point of this analysis was a data set in which individual CLEC line counts were reported by ILEC wire center in which the CLEC is collocated.
2. This information was combined with the ILEC switched line counts and the serving area (square miles) of the same wire centers.⁹⁶
3. Customer density for CLECs and ILECs was calculated for each wire center in which the CLECs are collocated.
4. Wire center level information was aggregated to the state level and an average (composite) CLEC was compared to the corresponding ILEC.
5. State-level data were compared across states within each ILEC's territory⁹⁷ and the minimum, maximum and average customer densities were recorded.⁹⁸

The results of this analysis are presented in the following two charts (based on a Voice Grade Equivalent or VGE basis):⁹⁹

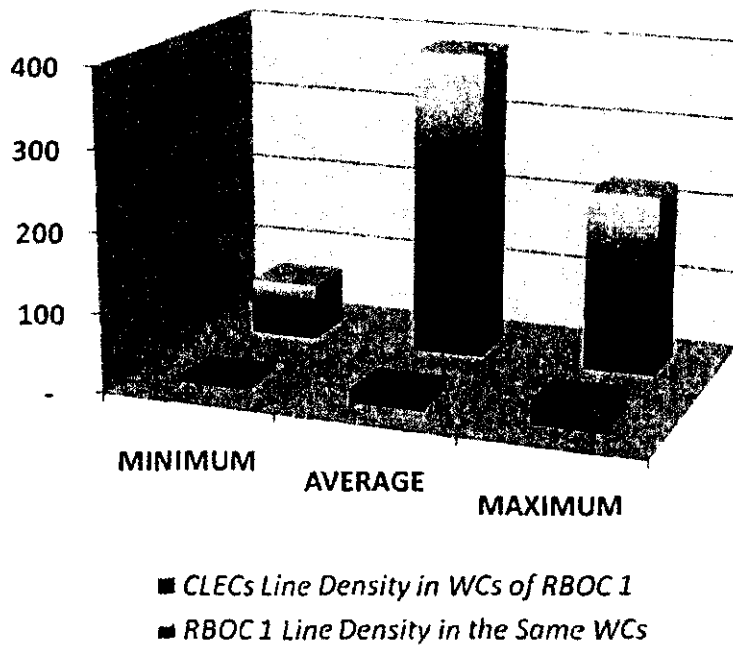
⁹⁶ The ILEC line counts are based on the following public data sources: Qwest's line counts are its 2007 business and residential line counts reported in its online Iconn database. The most recent public data source for wire center level line counts of other ILECs is the FCC Synthesis Model (the 2000 model results available at the FCC web site). While it is likely that the ILEC line counts (and hence, customer density) decreased compared to 2000, the difference between the CLEC and ILEC customer density (when based on the ILECs' 2000 line counts) is too significant (as shown on charts below) to be erased if the more recent ILEC line count is used. Further, because the 2000 Synthesis Model line counts are close in the vintage date to the date of the FCC CLEC Access order (the order that set the benchmark for CLEC access charges), the use of 2000 line counts is fair. Finally, the ILEC customer density calculated using the 2000 switched line data does not fully capture today's customer base of the ILECs because it excludes the ILECs' special access, Internet (DSL) lines, long-distance customers and video customers.

⁹⁷ Because of the data limitations, this analysis was performed for the territory of two (out of three) RBOCs.

⁹⁸ While the "RBOC Average" corresponds to the RBOCs' average across all wire centers/states, the "RBOC Minimum" and "RBOC Maximum" are the measures of RBOC density in wire centers where the Minimum and Maximum CLEC densities are observed. In other words, while the RBOC may have the maximum customer density in state A, the CLEC may have the maximum customer density in state B. In this case the chart depicts the RBOC and CLEC customer densities in state B.

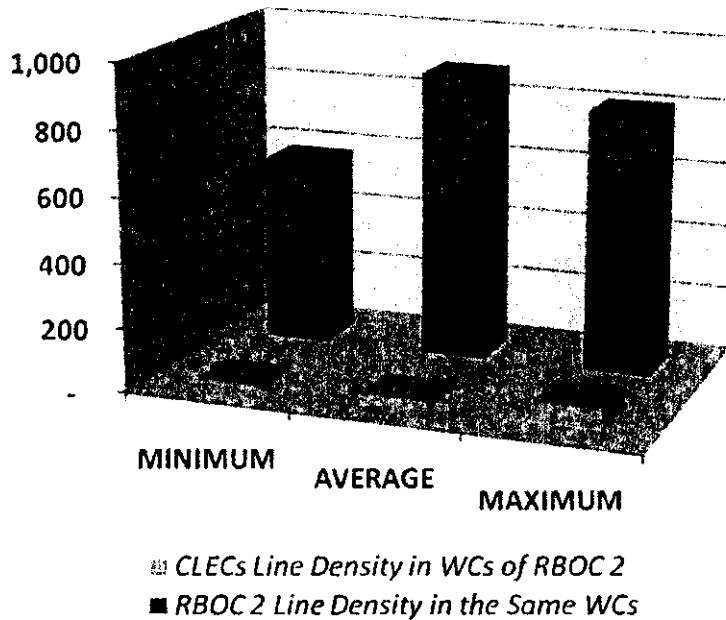
⁹⁹ As explained above, in order to preserve the data confidentiality, the operating territories are identified simply as "RBOC 1" and "RBOC 2."

**Comparison of CLEC and ILEC Line Density
in Wire Centers Where CLECs are
Collocated: Territory of RBOC 1**
*(VGE lines per square mile by state; CLEC Density is a
Weighted Average of CLECs in the Study)*



Comparison of CLEC and ILEC Line Density in Wire Centers Where CLECs are Collocated: Territory of RBOC 2

(VGE lines per square mile by state; CLEC Density is a Weighted Average of CLECs in the Study)



These two charts demonstrate that in both territories (the territories of RBOC 1 and RBOC 2), an individual CLEC's customer density is significantly lower than the customer density of the corresponding RBOC. This observation is true on average and at the extremes. Numerically, the gap between the average customer density depicted in the above charts (the relative heights of the "Average" bars) is as follows: An individual CLEC's customer density is 24 times lower than the incumbent's density in the territory of RBOC 1, and 35 times lower than the incumbent's density in the territory of RBOC 2. The following table lists these results (column (c)), along with an additional data point, which is RBOC's statewide customer density (column (d)):

Average Line Densities: CLECs versus RBOCs (VGE lines per sq. mile)

Territory	Wire Centers with CLECs' Collocations			RBOC Statewide (Same States)
	Average Line Density per CLEC	RBOC Line Density	Ratio: RBOC Density Over CLEC Density	RBOC Line Density
Column	(a)	(b)	(c)	(d)
RBOC 1	16	389	24	50
RBOC 2	25	893	35	158

This table shows that a CLEC's average customer line density (column (a)) is lower than the incumbent's density when the comparison is performed in the wire centers where the CLECs operate (which may be relatively more urban/dense wire centers) as well as when the CLEC's line density is compared to the ILEC's statewide line density (column (d)) which accounts for the ILECs' rural areas.

Another data source that supports our findings is a recent study of CLEC line counts in the Minneapolis-St. Paul Metropolitan Statistical Area ("MSA") conducted by the Minnesota Department of Commerce and filed in Ex Parte Comments of the Minnesota Public Utilities Commission in the FCC docket WC No. 07-97.¹⁰⁰ This study represents a fairly comprehensive survey of CLEC line counts in the Minneapolis-St. Paul MSA as it contains aggregate line counts of ten major CLECs in the state.¹⁰¹ QSI combined the line counts reported in this study with Qwest's publicly available switched residential and business line counts to derive average line densities for CLECs and Qwest in the Minneapolis-St. Paul MSA's wire centers. The resulting line densities¹⁰² are contained in the table below:

¹⁰⁰ Ex Parte Comments of the Minnesota Public Utilities Commission dated February 8, 2008 in FCC docket WC No. 07-97 *In the Matter of Petition of Qwest Corporation Pursuant to 47 U.S.C. para. 160(c) in the Minneapolis/St. Paul Metropolitan Statistical Area* (Qwest's Forbearance Petition).

¹⁰¹ The ten CLECs include AT&T/TCG, Covad, Eschelon, Integra, MCImetro, McLeodUSA, Onvoy, Popp, TDS Metrocom and XO.

¹⁰² Note that this measure of CLEC line density is different from the measure used in QSI's analysis of CLEC proprietary data because the MN PUC Ex Parte contained only CLEC-total line counts for each wire center, while each individual CLEC may not be present in each wire center.

Average Line Densities in Minneapolis/St. Paul MSA: CLECs versus Qwest
(Lines per Sq. Mile)

Wire Centers in Minneapolis/St. Paul MSA			All MN Qwest Wire Centers
Average Line Density per CLEC		Qwest Line Density (Switched Lines)	Qwest Line Density (Switched Lines)
Mass Market	Mass Market and Enterprise Market		
3	16	429	73

This table shows the gap between the average line density of the ten CLECs in the Minneapolis-St. Paul MSA and Qwest. This magnitude of this gap is striking, even when enterprise CLEC counts are included. (Compare the CLEC density of 16 lines per square mile with Qwest's density of 429 lines per square mile in the same wire centers). What's more, the CLEC line density is several times lower than Qwest's statewide line density despite the fact that the later measure includes more rural/sparsely populated areas of Minnesota.

To summarize the analysis of line densities, CLECs' customer densities are significantly smaller than the RBOCs' customer densities in markets where they compete. Although a lack of data does not permit a full analysis of customer density for mid-size/rural ILECs, the following observations made by Windstream in the recent Texas USF case¹⁰³ illustrates the relationship between RBOCs, CLECs and mid-size ILECs in terms of customer densities: AT&T has 94 access lines per square mile in Texas, Embarq has only 27 lines, and Windstream has only 7 lines per square mile.

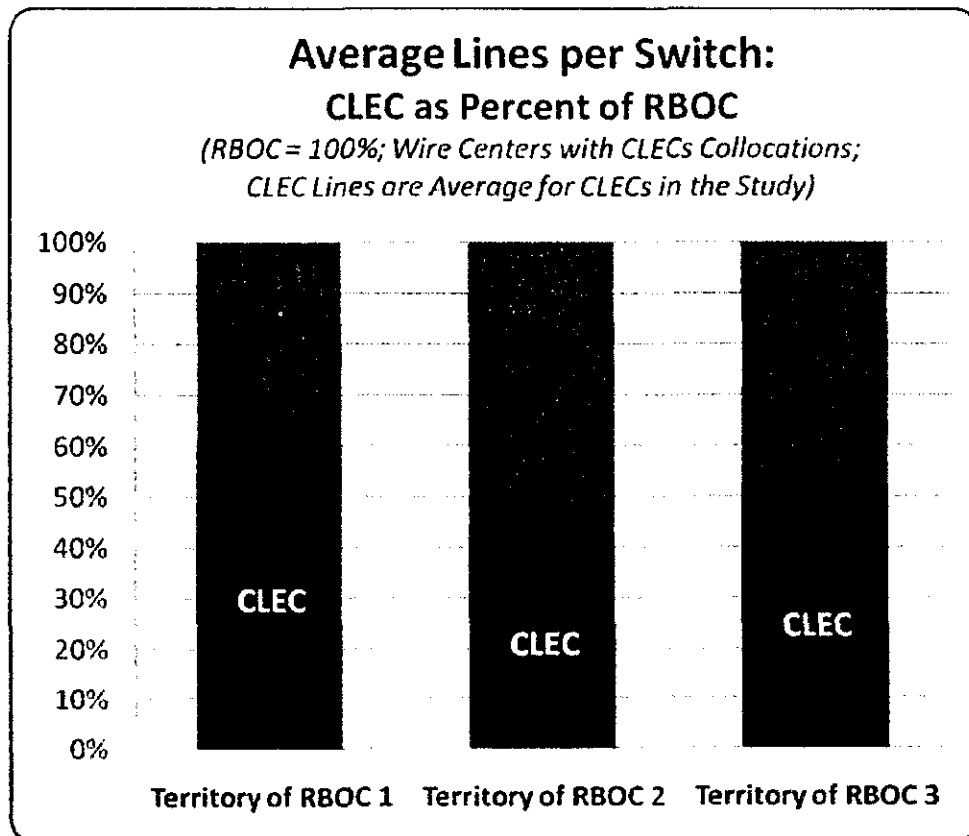
As regulators know from TELRIC and other cost proceedings, customer density is a major cost driver in cost studies. Higher customer density means that certain costs are lower and vice versa. In fact, it is in recognition of this close relationship between customer density and ILEC costs that most regulatory commissions have established different rate zones for UNE rates in TELRIC proceedings, such as urban, suburban and rural rate zones; *i.e.*, rate zones in large part coincide with customer density. Thus, given that the customer bases of CLECs are sparser (or less dense) relative to say, AT&T and Verizon (even in geographic regions in which CLECs compete with AT&T and Verizon), the CLECs' costs are higher on a per unit basis. This effect is partially moderated by the fact that CLECs tend to use the ILECs' UNE loops at TELRIC prices that reflect the ILECs' costs. However, these UNE loops are typically aggregated in collocation arrangements at the ILECs' central offices; from these collocation arrangements, the CLECs then require transport facilities from the ILEC central offices to the CLECs' switch locations. The cost of these transport facilities *are* part of the usage sensitive costs

¹⁰³ Texas PUC case No. 34723, Direct Testimony of William F. Kreutz (Windstream), November 30, 2007, p. 16.

of switched access. They are also costs not incurred in the same manner by ILECs and reflect the fact that the CLECs' have a *sparser* customer base.

The CLECs' networks reflect the low density of their customer bases. Only when their customer base approaches the ILECs' in terms of customer density, the CLECs may deploy more switches to cover certain geographic areas and fewer transport facilities. The use of more switches for certain geographic areas would be economically justified by the larger number of customers. Until that time, CLECs need to aggregate customer loops over larger geographic areas. This also means that they incur more transport costs (for the transport facilities used to connect the UNE loops to their switches.)

Another consequence of low customer density is that CLEC switches often support *fewer* lines than ILEC switches despite the fact that a CLEC's switch aggregates traffic over a large territory. QSI made this observation while analyzing the above discussed proprietary line count data of its client CLECs. The following chart depicts this finding:¹⁰⁴



¹⁰⁴ As explained above, in order to preserve the data confidentiality, the operating territories are identified simply as "RBOC 1," "RBOC 2" and "RBOC 3."

This chart depicts average CLEC lines per CLEC switch (blue bars) as a percent of RBOC lines per RBOC switch, and shows that an average CLEC has less lines per switch than an RBOC in which territory the CLEC operates. Thus, even though the CLEC switch may aggregate customers over a larger area than RBOC switch, the CLEC switch will still experience lower levels of utilization.

ii. *CLEC Customers Tend to Be Located at a Greater Distance from the Serving Switch than ILEC Customers*

Some of the shortest loops for ILECs are found in their densely populated urban serving areas. Even in those densely populated areas, however, CLEC customers tend, on average, to be located farther from the CLEC's serving central office relative to the distance ILEC customers are from the ILEC central office.

The distributed network architecture employed by CLECs allows customers at great distances from the central office to be connected via transport facilities. CLECs lease existing ILEC loops running between the end user customer's premise and the ILEC's serving central office. When unbundled loops are used, the CLEC still needs to carry the calls generated over those end-user loops with *transport facilities* from the ILEC's serving central office, either directly all the way to the CLEC's own switch or to an "intermediate" ILEC central office where the CLEC has collocated its equipment and then to the CLEC's switch.

The fact that CLECs have longer loops does not necessarily warrant higher access rates, but the fact that these longer loops involve additional traffic sensitive costs related to the *collocation facilities* and *transport components* does. It is important to note that these additional costs for transport and collocation functions are traffic sensitive costs¹⁰⁵ and that they are associated with terminating and originating exchange access traffic. Thus, given that these costs would be incurred even by an optimally efficient CLEC, these costs are legitimate costs to be recovered.

It would be bad public policy for regulators to hold CLECs to a standard, implicit in benchmarking policies (i.e., meet the ILECs' rates or exit), that even an optimally-efficient carrier could not meet. Traditionally in public utility regulation, the notion of just and reasonable rates involves a reasonable opportunity for carriers to recover their reasonable costs. If the standard is set, however, at a level at which even an optimally efficient carrier is unable to recover its reasonable costs, then those rates, as a matter of economics, cannot be just and reasonable.

¹⁰⁵ Many collocation costs are usage sensitive in the same way that trunk ports on a tandem switch are usage sensitive: the larger is the volume of calls, the more trunking facilities will terminate in the collocation space and the more terminating facilities, floor space and power are needed.

F. CLECs Tend to Have Higher Input Costs than the Largest ILECs

Large buyers typically are able to extract better input prices from suppliers than small buyers. AT&T and Verizon, as the nation's largest telecommunications firms, are also the nations' largest purchasers of telecommunications equipment. This gives them significant bargaining power and they are able to negotiate discounts by shifting the bulk of their purchases to the supplier that is willing to offer the best deal. Regulators are well aware of those discounts and have examined them in various proceedings in which large ILEC costs are at issue.¹⁰⁶

Given that one of the most important determinants of costs of a service is the price of the inputs used to provide that service, CLECs will invariably have higher costs associated with exchange access services than the large ILECs. As input prices increase, so does the cost of service. In fact, the relationship between the level of input prices and the costs that are to be calculated is almost linear in the sense that if input prices double, then one should expect the costs to double. The table below illustrates this relationship for a hypothetical facility, following a traditional layout for a cost study. As can be seen from the table, when hypothetical input prices are \$100, the monthly cost is calculated to be \$3.33; when input prices double (*i.e.*, increase to \$200), then the monthly cost doubles as well.

EF&I Facilities ¹⁰⁷	Fill Factor	ACF ¹⁰⁸	Monthly Costs
(a)	(b)	(c)	((a)/(b)x(c))/12
\$100	80%	0.32	\$3.33
\$200	80%	0.32	\$6.67

By contrast, the CLECs are much smaller and purchase fewer facilities and equipment than do, say, AT&T and Verizon. As a result, CLECs do not have the bargaining power of the large ILECs to induce suppliers to offer substantial discounts or to bid against one

¹⁰⁶ See, e.g., California Public Utilities Commission *Rulemaking on the Commission's Own Motion to Govern Open Access to Bottleneck Services and Establish a Framework for Network Architecture Development of Dominant Carrier Networks, Investigation on the Commission's Own Motion into Open Access and Network Architecture Development of Dominant Carrier Networks*, Decision 06-03-025, Rulemaking 93-04-003; Investigation 93-04-002 (Verizon UNE Phase), Dated March 15, 2006. See also, Illinois Commerce Commission Docket No. 02-0864 *Order Illinois Bell Telephone Company Filing to Increase Unbundled Loop and Nonrecurring Charges*, Dated June 9, 2004; and Georgia Public Service Commission Docket No. 14631-U *In RE: Review of Cost Studies, Methodologies, Pricing Policies, and Cost Based Rates for Interconnection and Unbundling of BellSouth Telecommunications, Inc.'s Services*, March 18, 2003.

¹⁰⁷ The term "EF&I" refers to the engineered, furnished and installed investment in facilities.

¹⁰⁸ The term "ACF" means annual cost factor, a factor used to convert the EF&I investment into an annual recurring cost stream. When these annual costs are divided by 12, they become monthly recurring costs.

another. In short, CLECs' input prices tend to be higher than those of the largest ILECs, such as AT&T and Verizon.

Furthermore, the prices of major inputs used by CLECs in the provisioning of exchange access – inputs that CLECs purchase from large ILECs – have been increasing. Competitive carriers purchase much of their transport and loop capacity supporting switched access services directly from AT&T, Verizon and Qwest in the form of special access services and UNEs. In many circumstances, these fees paid by the CLECs can constitute as much as 40% to 60% of their overall cost structure. Since the FCC originally issued its *CLEC Access Reform Order* in 2001, prices paid by CLECs to purchase loops and transport services from the large incumbents have increased substantially, more than doubling within some companies. These increases result largely from the fact that AT&T, Verizon and Qwest have used increased pricing flexibility granted by the FCC to increase special access prices in critical markets while at the same time limiting access to less-costly UNE products per the FCC's finding of non-impairment in certain areas in its *Triennial Review Remand Order*. Special access services and switched access services work as effective substitutes in the overall market for telecommunications capacity. Where switched access prices are too high, carriers always have the ability to connect directly to the customer via special access and bypass the switched provider. Yet, even as the large ILECs increase prices for dedicated capacity, they are at the same time demanding that regulators force CLECs to reduce switched access rates their affiliated IXCs pay when they use those facilities to originate or terminate toll traffic. With this in mind, it is not surprising that AT&T and Verizon attempt to convince regulators that the CLECs' costs should be ignored in establishing reasonable switched access rates – digging too deeply into CLEC costs is sure to highlight the “have their cake and eat it too” attitude of the large ILECs.

In sum, even if a CLEC had a customer base identical to the large ILECs' in terms of customer densities (though not size), a network architecture identical to the large ILECs (though smaller), and ran its operations with the same level of efficiency, the CLEC's costs associated with providing switched access services would still be higher than the large ILECs' because it pays *higher prices* for its network facilities than do the large ILECs.

G. CLECs Are Forced To Bear the Capacity Risks for Accommodating IXC Traffic

One important aspect of the exchange access provider / IXC relationship that is often overlooked is that exchange access services that are sold on a traditional per minute-of-use basis forces the provider of exchange access services to bear all of the *capacity risk* associated with deploying fixed capital. Traditional switched access arrangements allow interexchange carriers to purchase access to local networks on a “minute-at-a-time” basis without any commitment as to volume or term. This structure is largely a vestige of the post-divestiture marketplace where the FCC and Judge Green were attempting to protect

fledgling long distance providers from the extreme economies AT&T could expect to enjoy when purchasing enormous switched access volumes from its prior Bell System brethren.¹⁰⁹ If all carriers could purchase a minute of switched access for the same price, AT&T was restricted from negotiating substantially better prices based upon its tremendous volumes. Today, long distance providers still largely enjoy the ability to terminate or originate calls on competitive local networks without the requirement that they purchase some minimum capacity or minutes of use volume. Unfortunately, that rate structure forces smaller, competitive LECs to invest in capacity sufficient to accommodate the totality of switched access traffic it may need to support, without any commitment or joint-planning that ensures they recover the costs of installing that necessary capacity.

For example, while AT&T may require 1,000,000 minutes-of-use from CLEC A in Month 1, it may well develop direct connections to large customers or move large amounts of traffic to alternative networks months later leaving the CLEC with investment in substantial capacity that it is now unlikely to recover. In short, CLECs bear substantial capacity risk (and cost) associated with maintaining their networks to accommodate what is largely "casual traffic" from IXCs that CLECs have little ability (physically or contractually) to manage and no assurances that the IXCs will in fact originate or terminate the necessary traffic volumes to recover their investments. While this is generally true for exchange access providers under the existing per minute-of-use exchange access regime, the capacity risks are greater for smaller carriers (like CLECs) because they face lumpier investment when adding new capacity. Those risks result in higher costs that are legitimately included in CLEC exchange access charges.

While it is conceivable that these types of capacity costs could be better managed through arms-length negotiations between IXCs and CLECs, unfortunately, the FCC's *CLEC Access Reform Order* – by establishing a baseline rate equal to the price per minute assessed by incumbent carriers – gives IXCs little incentive to consider anything more or different. In other words, the ability of CLECs to provide stand-by capacity is fundamentally undermined by a benchmarking policy that forces CLECs to provide exchange access services at rates that are generally not compensatory. Expanding a benchmark policy to CLEC *intrastate* exchange access rates further reduce incentives for more rational agreements.

¹⁰⁹ As the FCC noted: "Prior to the FCC's 1993 restructuring of local transport rates, LECs recovered their transport costs through a rate structure based on the "equal charge per minute of use" requirement in the Modification of Final Judgment (MFJ). The "equal charge per minute of use" rule required that the Bell Operating Companies charge an equal amount per unit of traffic for delivery or receipt of traffic of the same type between end offices and IXC POPs within an exchange area. This approach essentially required all interstate access service customers to pay averaged rates. The actual type of facilities --voice grade, DS1, or DS3 -- that were used to transport a customer's traffic between the IXC POP and the LEC serving wire center did not affect the charges that were assessed, because the rates were usage-sensitive and, generally, distance sensitive. Under the terms of the MFJ, the equal charge rule expired on September 1, 1991." See, *In the Matter of Transport Rate Structure and Pricing Resale, Shared Use and Split Billing*, Report and Order, CC Docket No. 91-213, Adopted February 27, 1998, para. 3.

H. CLECs Should Not Be Asked To Shift Under-Recovered Traffic Sensitive Costs onto End Users

Some advocates of benchmarking have suggested that CLECs should recover their costs of providing exchange access services from end-users if a regulatory benchmark/cap results in below cost exchange access rates for CLECs. This suggestion is misguided for the following reasons.

First, this suggestion ignores the fact that the CLECs do not have nearly as much ability as the large ILECs to recoup network costs by raising the rates for services with flat-rated, non-usage sensitive rates (like monthly local telephone service). CLECs compete in local exchange markets and must meet or beat prevailing end user prices. This means that they cannot simply increase their rates to recover costs unrelated to the provision of local exchange services. That is, aside from the fact that such a cross-subsidy is unjustified, markets dynamics won't tolerate it.

Further, as explained above, the typical CLEC network architecture generates more traffic sensitive costs than the ILEC network architecture. This is true because CLECs deploy relatively more transport facilities than ILECs and they require collocation facilities. The costs of both transport and collocation facilities tend to be traffic sensitive. Further, much of the CLECs' traffic is off-net traffic. The combined effect is that a much larger portion of CLECs' overall costs are traffic sensitive. This also means that any under-recovery of exchange access related costs – i.e., traffic sensitive costs – weighs more heavily on the CLEC than on the ILEC and causes a much larger shift of unrecovered costs to other customers or services.

Last, the recommendation falsely suggests that ILECs are doing the same. However, ILEC exchange access rates have *not* explicitly been set below the ILECs' costs of providing exchange access services – as benchmarking would for CLEC. To the contrary, all indications are that the ILECs' exchange access rates are compensatory. Thus, forcing CLECs to shift under recovered exchange access costs to their end-users puts the CLECs at a severe competitive *disadvantage* in the retail market.

VII. CONCLUSION

Contrary to recent advocacy by the large, vertically-integrated ILECs/LXCs that there is market failure that distorts CLEC exchange access rates, the data show that there is no systemic problem: as we have shown, CLEC exchange access rates, on average, are reasonable and not indicative of market power. In fact, when compared to the rates of other carriers, CLEC exchange access rates are at levels one would expect them to be given the disparate cost characteristics of various carriers – i.e., slightly higher than large ILECs but lower than the mid-sized and small ILECs.

Because CLEC rates, on the whole, are reasonable, there is no need for “broad brush” regulatory intervention into presumptively competitive segments of telecommunications markets, particularly when that intervention involves singling out CLECs who are already facing higher exchange access input costs (i.e., increasing rates for collocation and transport) at the hands of the same carriers that are demanding lower exchange access rates.

Further, we have demonstrated that benchmarking policies are inappropriate for many reasons: they prevent CLECs from recovering legitimately incurred costs, they cause cross-subsidies without valid policy justifications, they strengthen the monopsony powers of large IXCs/ILECs (which already threatens to undermine retail competition), and they force CLECs to charge exchange access rates that were developed for entirely different carriers under *quid pro quo*s (e.g., revenue neutrality) that don’t apply to CLECs.

In sum, benchmarking policies are, at best, bad public policy and, at worst, a convenient regulatory shortcut by the large vertically integrated IXCs/ILECs to subduing CLECs and increasing their own bottom line at the expense of local competition and society at large.

ATTACHMENT I

A FORMAL FRAMEWORK FOR MARKET DOMINANCE ANALYSIS FOR CLEC EXCHANGE ACCESS SERVICES

The central question in a market dominance analysis is whether a firm has market power; in the current instance: *do CLECs have market power in the provision of exchange access services?*

A formal analysis of this issue requires the following:

1. A definition of market power.
2. A definition of the product market and the geographic dimensions of the market.
3. Market share analysis.
4. A final assessment of all demand and supply responses in reaction to an attempted exercise of market power: i.e., an assessment of whether or not the attempt will succeed or be defeated.

i. Market Power

Market power is defined in the *Horizontal Merger Guidelines* as follows:

Market power to a seller is the ability profitably to maintain prices above competitive levels for a significant period of time.¹¹⁰

Implied in this definition is the notion that competitive prices are compensatory only in the sense that they provide for a natural rate of return (*i.e.*, zero economic profits), and any returns above the competitive levels would be competed away as long as the market is competitive. Conversely, if the market is not competitive, then a seller's attempt at extracting excessive or "positive economic" profits will succeed. If those positive economic profits are sustained for a significant period of time, then the seller is deemed to possess market power.

Drawing on this theoretical framework, the FCC uses a definition of market power in the forbearance proceedings that is essentially the same as the DOJ's and FTC's:¹¹¹

Market power is defined as "the ability to raise prices by restricting output," or "to raise and maintain price above the competitive level

¹¹⁰ *Horizontal Merger Guidelines* at Section 0.1 (emphasis added). U.S. DOJ and FTC Horizontal Merger Guidelines available at: http://www.usdoj.gov/atr/public/guidelines/horiz_book/toc.html

¹¹¹ *Qwest Omaha Forbearance Order* at note 54.

without driving away so many customers as to make the increase unprofitable.”

Given this generally accepted definition of market power, the next step in completing a market dominance/market power analysis is to define the product and the geographic dimensions of the market.

ii. Market Definition

The ultimate purpose of defining the market is to ensure that the subsequent market dominance/market power analysis reflects all the relevant demand responses and supply responses that may cause a firm to fail in its attempt to exercise market power. In doing so, a market should not be defined too narrowly because it may exclude possible competitors (and products) and lead to an erroneous conclusion that a firm has market power. A market should also not be defined too broadly because it may suggest the presence of alternatives that are not truly available, and lead to an erroneous conclusion that a firm does not have market power. To define the proper scope of the market, the *Horizontal Merger Guidelines* approach the market definition process as follows:

A market is defined as a product or group of products and a geographic area in which it is produced or sold such that a hypothetical profit-maximizing firm, **not subject to price regulation**, that was the only present and future producer or seller of those products in that area likely would impose at least a "small but significant and nontransitory" increase in price, assuming the terms of sale of all other products are held constant. (Emphasis added.)

[...]

A relevant market is a group of products and a geographic area that is no bigger than necessary to satisfy this test. The "small but significant and non-transitory" increase in price is employed solely as a methodological tool for the analysis of mergers: it is not a tolerance level for price increases.

Using this approach, two dimensions of the market need to be defined: the product market and the geographic market.

As with market power, the FCC has generally adopted the *Horizontal Merger Guidelines* framework in its market dominance analyses.¹¹² For example, in the *Qwest Omaha Forbearance Order*, the FCC found as follows:

¹¹² See for example, the FCC's *LEC Classification Order*, in which the FCC found: "With respect to market definition, we adopt the approach proposed in the Notices. Specifically, we revise our current product and geographic market definitions in accordance with the 1992 *Merger Guidelines*." *Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area*, CC Docket No. 96-149, Second Report and Order in CC Docket No. 96-149 and Third Report and Order in CC Docket No. 96-61, 12 FCC Red 15756, 15776, 15782 (1997) (*LEC Classification Order*).

The Commission defines relevant *product* markets by identifying and aggregating consumers with similar demand patterns. The Commission has also explained that “[a] *geographic* market aggregates those consumers with similar choices regarding a particular good or service in the same geographical area,” and that it would “treat as a geographic market, an area in which all customers in that area will likely face the same competitive alternatives for a product.”¹¹³

Thus, the FCC also brackets the total market by defining a product market dimension and a geographic market dimension. Further, the FCC’s objective is the same as the DOJ’s and the FTC’s: to capture all relevant demand and supply responses.

iii. Product Market

With respect to the question of whether CLECs have market power in the provision of exchange access services, the broadest definition of the relevant product market would be the total market for exchange access services – the origination and termination of calls from or to end-user customers. In the *Qwest Omaha Forbearance Order*, in which the FCC explicitly examined the issue of market power in the provision of switched access service, the FCC opted for a slightly narrower and more granular product market and bifurcated its analysis into a mass-market segment and an enterprise segment:

Accordingly [...] we divide these interstate services into the mass market (residential consumers and small business customers) and the enterprise market (medium-sized and large business customers). Our analyses of the mass market and enterprise market are not identical to, but are in accordance with, the Commission’s past product market analyses for those services. In addition, we also separate out mass market broadband Internet access services, consistent with the Commission’s separate review of that market in prior merger proceedings. Thus, within the mass market we look at both *switched access services* and broadband Internet access services. For the purposes of assessing forbearance from dominant carrier regulation, we reject suggestions from commenters that our section 251(c)(3) network element unbundling precedent controls our market framework.¹¹⁴

[...]

Unlike these decisions, which included local exchange service and exchange access services in the same product market, *here we only examine exchange access services* because section 10(a) focuses our inquiry on the target services to which our regulations apply.¹¹⁵

¹¹³ *Qwest Omaha Forbearance Order*, ¶ 18.

¹¹⁴ *Omaha Forbearance Order*, ¶ 22. (emphasis added)

¹¹⁵ *Id.* at note 64. (emphasis added)

It is important to note that the FCC explicitly rejected proposals for narrower definitions of the product market, offered by some parties. For example, the FCC rejected notions that the market should be defined in terms of the underlying wholesale facilities for loops and transport.¹¹⁶ In any event, for purposes of this analysis, we adopt the above product market definition the FCC used in the *Qwest Omaha Forbearance Order*.

iv. Geographic Market

As with the product dimension of the market, the geographic dimension of a market in a market dominance analysis is defined by postulating a large, single provider and then asking the question: what should the geographic size of the market be so that the firm would be able to sustain a small but significant and non-transitory price increase? The notion is that if the market is defined too small, then consumers would be able to go “next door” to purchase the product at a lower price, which means that “next door” should have been included in the geographic scope of the market. On the other hand, to avoid the selection of an overly expansive geographic market, the *Horizontal Merger Guidelines* applies the principle of the “smallest market”:

The “smallest market” principle will be applied as it is in product market definition. The price for which an increase will be postulated, what constitutes a “small but significant and nontransitory” increase in price, and the substitution decisions of consumers all will be determined in the same way in which they are determined in product market definition.¹¹⁷

Within the context of the issue under consideration – whether or not CLECs have market power in the provision of exchange access services – the geographic dimensions may be usefully defined as the entirety of the service area in which local exchange carriers compete. That is, the geographic market is the entire service area in which ILECs and CLECs compete for end user customers. This geographic market definition follows the FCC’s geographic market definition for switched access services in the *Qwest Omaha Forbearance Order*:

Qwest also states that its service territory in the Omaha MSA includes 24 wire centers in the Omaha MSA, and that it therefore seeks relief throughout the territory served by those wire centers. In its Petition, Qwest filed retail market data regarding the entire MSA, without disaggregating the state of competition by county, zip code, wire center or other more narrow geographic market.¹¹⁸

[...]

¹¹⁶ *Id.* at note 67.

¹¹⁷ *Horizontal Merger Guidelines*, at Sec. 1.2.1

¹¹⁸ *Qwest Omaha Forbearance Order*, ¶ 23.

For the purposes of analyzing dominant carrier regulation of Qwest in this proceeding, *we define the relevant geographic market here to be Qwest's service area in the Omaha MSA. Qwest has proposed its service territory as the market and submitted its case consistent with that definition, so we begin our analysis with that region as the relevant geographic market unless the record indicates compelling reasons to narrow it.*¹¹⁹

Thus, for purposes of analyzing whether CLECs have market power in the provision of exchange access services, we will define the geographic market as the entirety of the service area in which ILECs and CLECs compete for end users.¹²⁰

While the above definition is consistent with the FCC's definition of geographic markets in its forbearance orders, it is important to note that there were some suggestions in the *CLEC Access Reform Order* of a narrower geographic market. Again, while the FCC never discussed the product market and the geographic market in its *CLEC Access Reform Order*, it did give a nod of approval to the IXCs' notion that exchange access services represent a series of bottleneck monopolies:

Sprint and AT&T persuasively characterize both the terminating and the originating access markets as consisting of a series of bottleneck monopolies over access to each individual end user. Thus, once an end user decides to take service from a particular LEC, that LEC controls an essential component of the system that provides interexchange calls, and it becomes the bottleneck for IXCs wishing to complete calls to, or carry calls from, that end user.¹²¹

While this observation may suggest an implied definition of the product market and geographic market, it is not. The observation that there is a "series of bottleneck facilities" should have been a *conclusion* that follows from a systematic market dominance analysis rather than, as in the *CLEC Access Reform Order*, an unsubstantiated premise. As it is, the FCC engaged in tautological reasoning in which premise and conclusion are meaninglessly intertwined. Further, as will be discussed below, under the provisions of the Telecom Act and in the post-mega-merger era, it can no longer be argued that there are "bottleneck facilities" not available to the large IXCs, such as AT&T and Verizon.

iv. Market Shares and an Assessment of Demand and Supply Responses for Mass Market and Enterprise Exchange Access Services

¹¹⁹ *Id.*, ¶ 24. (emphasis added)

¹²⁰ Many states adopted narrower geographic market definitions, at the wire center level, during the FCC's mandated Triennial Review Order proceedings concerning unbundled the local switching. It should be noted, however, that those proceedings addressed whether CLECs were impaired without access to unbundled local switching, not whether any entity possessed market power; these are very different questions, warranting different geographic market definitions.

¹²¹ *CLEC Access Reform Order*, ¶ 30. (footnotes omitted)

To evaluate the impact of potential market responses to an attempted exercise of market power (*i.e.*, an increase in price above competitive levels), the *Horizontal Merger Guidelines* provide an extensive discussion of not only potential customer demand responses but also the presence of alternative providers in the market. In this section, we discuss market shares, demand responses and supply responses.

Market Shares

The *Horizontal Merger Guidelines* considers two sets of alternative providers who can apply competitive pressures to defeat an attempted price increase: currently existing providers and potential entrants. An evaluation of the impact of alternative providers typically involves some assessment of relative market shares.

The FCC follows this same general approach in market dominance analyses. For example, in the *Qwest Omaha Forbearance Order*, the FCC focused on the relative market shares of Qwest and its main competitors, specifically Cox Communications.

Given that the issue under investigation concerns whether or not CLECs have market power in the provision of exchange access services, the relevant question is: what are the market shares of CLECs, individually, relative to the total size of the market? As can be seen from the table below taken from the FCC's Local Competition Report, collectively, CLECs still constitute but a small percentage of local exchange markets.¹²²

¹²² FCC *Local Competition Report*, 2007. Table 1.

End-User Switched Access Lines Reported

Date	ILEC Lines	CLEC Lines	Total	CLEC Share
Dec 1999	181,202,853	8,194,243	189,397,096	4.3 %
Jun 2000	179,648,725	11,557,381	191,206,106	6.0
Dec 2000	177,561,022	14,871,409	192,432,431	7.7
Jun 2001	174,752,275	17,274,727	192,027,002	9.0
Dec 2001	171,917,359	19,653,441	191,570,800	10.3
Jun 2002	167,330,006	21,644,928	188,974,934	11.5
Dec 2002	164,386,452	24,863,691	189,250,143	13.1
Jun 2003	158,274,538	26,985,345	185,259,883	14.6
Dec 2003	153,157,843	29,775,438	182,933,281	16.3
Jun 2004	147,993,218	32,033,915	180,027,133	17.8
Dec 2004	144,809,899	32,880,812	177,690,711	18.5
Jun 2005	143,757,708	33,975,336	177,733,044	19.1
Dec 2005	143,773,101	31,387,839	175,160,940	17.9
Jun 2006	142,293,047	29,896,109	172,189,156	17.4
Dec 2006	138,833,928	28,625,971	167,459,899	17.1
Jun 2007	134,458,920	28,711,461	163,170,381	17.6

Only LECs with at least 10,000 lines in a state were required to report through December 2004. Beginning with the June 2005 data all LECs are required to report. Some historical data have been revised.

While exact numbers for individual CLECs are not available, the individual market shares, of course, will generally be only a fraction of the overall market share of the CLECs. To place the market share information in context of a market power analysis, one should recognize that courts virtually never find market power when market shares are less than 50 percent.¹²³ The FCC used approximately the same market share levels for assessing whether petitioners in forbearance petitions have market power.¹²⁴

The above graph further underscores that the competitive landscape has fundamentally changed since the FCC's *CLEC Access Reform Order*. The harm is not only a result of CLECs' loss of access to ILECs' unbundled local switching and other UNEs in certain markets; perhaps more significantly mega-mergers between large RBOCs and large IXC's have directly and indirectly harmed CLECs' abilities to compete. These developments warrant a fresh look at the assumptions underlying the FCC's benchmarking policies.

¹²³ A.B.A. Section of Antitrust Law, *Antitrust Law Developments* at 235-236 (4th ed.) (1997), cited in the FCC *Verizon Forbearance Order* at footnote 99.

¹²⁴ A.B.A. Section of Antitrust Law, *Antitrust Law Developments* at 235-236 (4th ed.) (1997), cited in the FCC *Verizon Forbearance Order* at footnote 99.

In any event, the CLECs' relatively low market shares – to be assessed on an individual basis – are not at all close to the level needed to raise concerns of market power.

v. Demand Responses

A CLEC will generally serve two classes of customers for its exchange access services: end users and carriers, such as IXCs. As the FCC and others have recognized, the price signals guiding end-user behavior may be distorted since IXCs are required to offer their services on an averaged basis under the FCC's current interpretation of section 254(g) of the Act. We discuss this prohibition in a separate section below and demonstrate the distortion that it creates. Due to such regulations IXCs are *unable* to fully affect end user behavior, on either the originating end or terminating end of the call, by reflecting in their prices the cost of access. It is important to note that this is not a failure of exchange access markets: *it is a failure of regulation*. Once this is recognized, it is clear that compounding the existing distortions by imposing further regulations is not the right direction in light of the Telecom Act's stated purpose of moving the industry onto a more competitive footing.

As for carrier demand responses, they also reflect a market distortion: near monopsony power on the part of the large IXCs, especially AT&T and Verizon. As will be discussed below, IXCs do have options of making different arrangements with CLECs for how to route their traffic. Most notably, IXCs typically opt to terminate traffic to CLECs based on the traditional per-minute-of-use basis, which is a pay-as-you-go arrangement. Under such an arrangement, CLECs assume the capacity risks of having sufficient stand-by capacity to accommodate all levels of IXC traffic volumes. Due to the smaller size and other characteristics of the CLECs' operations (discussed below), CLECs have lower levels of utilization of this stand-by capacity than the larger ILECs. This also means that per minute-of-use exchange access rates may be higher than IXCs would prefer. A possible demand response could be for the IXC to share the capacity risk. After all, IXCs are far better informed about expected traffic volumes coming from their customers and are well positioned to make arrangements for optimally sized and relatively more efficient dedicated facilities, which would normally be priced on a flat-rated basis. These types of arrangements could save money and would only require additional negotiations between IXCs and CLECs.

However, to our knowledge, few such negotiations have occurred. As discussed elsewhere in this paper, we believe that this is due to the monopsony powers of the large IXCs, such as AT&T and Verizon. Rather than negotiate in good faith, the large IXCs have often bullied CLECs and, indeed, outright refused payments. While this is problematic in its own right, with respect to the discussion at hand it means that the absence of carrier demand responses in the form of alternative arrangements does not signify market power of CLECs in exchange access services – rather, it signifies near monopsony power on the part of the IXCs. Imposing price regulations on CLECs is the wrong response to IXC monopsony power.

vi. Supply Responses

Supply responses are generally determined by the extent to which there are *barriers-to-entry* that keep existing and potential providers at bay. As discussed below, due to the local entry strategies made available in the Telecom Act and the vertical integration brought about by the mergers of ILECs and IXCs, it cannot be convincingly argued that the vertically integrated IXCs (AT&T, Verizon and Qwest) face barriers-to-entry that would allow a CLEC to earn supernormal exchange access profits without a competitive response.

Incumbent LECs have an obligation to make available unbundled loop facilities¹²⁵ (or the last mile to the end user customer) to all properly certificated would-be competitors under the pro-competition provisions of the Telecom Act. Moreover, the large IXCs, such as AT&T and Verizon, own and operate the last mile loop facilities, including those that are used by the CLECs to serve most of their local exchange customers. Further, the FCC has found that switching is no longer a bottleneck facility (and, the large vertically integrated IXCs, such as AT&T and Verizon, again, own and operate much of the switching facilities in the country). Under current regulations, most transport facilities are also available to all properly certificated would-be competitors.¹²⁶ In addition, most IXCs already have customer contact information and billing systems set up because the CLECs' end users are also the IXCs' end users for either originating or terminating long distance services or wireless services.

That CLECs face competitive pressures in exchange access pricing is evident from the fact that the giant ILEC-IXC conglomerates (the CLECs' primary competitors) own the last-mile loops over which most CLEC end users are served and serve many CLECs' end user customers use the conglomerate's IXC that, as a result, may pay access to the CLEC. For example, if a CLEC is serving an end user customer in Chicago via AT&T Illinois' UNE loop and that CLEC end user is presubscribed to AT&T Long Distance as his or her long distance carrier, AT&T will be billed by the CLEC for originating access when that customer places a long distance call through AT&T. If AT&T Long Distance believes that the CLEC's exchange access rates are too high, its affiliate AT&T Illinois (the owner of the loop over which the CLEC's end user is served) could simply attempt to win that customer away from the CLEC so that AT&T Long Distance can avoid paying the CLEC's access charges. And given AT&T's ability to serve residential, small business and enterprise services and provide Triple Play service bundles (local telephone, wireless and high speed internet services) and more,¹²⁷ it certainly has the means to attract CLEC customers. Given this example, which would also apply in Verizon's local territory, BellSouth's local territory and Qwest's local territory, it is concerning that RBOCs/IXCs

¹²⁵ It should be noted that there are exceptions to this for high capacity loops when an ILEC has met the non-impairment criteria established by the FCC in the TRRO.

¹²⁶ Transport is not available as a UNE along certain routes that have been shown to meet that the non-impairment criteria of the TRRO although substitute circuits are usually available as the more expensive special access.

¹²⁷ AT&T also offers digital television in some areas.

are appealing to regulators to cap CLEC exchange access rates when those same RBOCs/IXCs have every means to avoid paying those access charges by competing for end user customers.

In short, any attempt by a CLEC to earn supernormal profits on exchange access services would be defeated by supply responses. Further, as discussed in a separate section below, companies compete for all revenues (and profits) associated with an end user. If certain end users become more profitable to serve, due to higher exchange access rates, then the market will respond by increased competition for those customers. That is, retail competition disciplines upstream, wholesale markets for exchange access services.

vii. Conclusion Market Power Analysis

We have demonstrated that CLECs lack market power in the provision of exchange access services. If a CLEC sets and collects exorbitant exchange access rates, then the overall revenues¹²⁸ associated with the CLEC's customers are high, and the customer is especially attractive to would-be competitors from a customer acquisition perspective. Given that AT&T and Verizon, in the post merger era, are fully vertically integrated companies, combining IXC and LEC operations, and have near ubiquitous facilities and operations, they are now uniquely positioned to compete for all CLEC customers (*i.e.*, large vertically integrated carriers, such as AT&T, Verizon and Qwest, face no barriers-to-entry).

Specifically, in order to build and preserve its customer base, a CLEC will be forced to (1) attract customers for which it has a competitive advantage and (2) set prices at levels sufficiently low so as not to dissipate its competitive advantage. Setting exchange access rates at exorbitant levels would forfeit any competitive advantages and be a self-defeating strategy as it would draw existing and would-be competitors into the segment of the market targeted by the CLEC, thus undermining the prospects of its long term success.

Taking all relevant supply and demand responses into consideration, the conclusion is that CLECs lack the ability to set prices higher than competitive levels for a non-transitory period: thus, they lack market power.

¹²⁸ A finding of market power requires that those revenues are also associated with supernormal profits.