02-00207

BELLSOUTH

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VIA HAND DELIVERY

Hon. Ron Jones, Director
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, TN 37238

02-00207

Dear Director Jones:

According to a press release issued by MCI on October 17, 2002, MCI recently sent a letter to utility commissions in all 50 states alleging that the incumbent local exchange carriers ("ILECs") are attempting to "kill competition." That allegation is absolutely untrue.

Attached to this letter is an explanation of BellSouth's actual position on the unbundled network elements–platform ("UNE-P") and its role in the competitive landscape. There are three important points, each of which are discussed in detail, that we would like to bring to the Authority's attention:

1) Where competitive alternatives are available, network elements should be market, not TELRIC, priced. TELRIC rated elements, taken in totality, are well below the actual cost of providing the network, and should not be continued in perpetuity;

2) Retail prices relative to wholesale prices must be realigned by zone; and

3) Long-term TELRIC pricing discourages facilities-based competition and potentially jeopardizes Carrier of Last Resort capabilities.

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There are a number of serious policy issues facing regulators all across the nation. The outcome of these decisions will impact CLECs and the future of facilities-based competition, incumbents and their ability to serve customers in the high cost, non-profitable areas, telecommunications equipment suppliers whose viability is closely tied to companies' incentives to invest, and, most importantly, consumers.

It is imperative that all the facts be presented to regulators before those decisions are made. Please feel free to let us know if you have questions.

Very truly yours,

Charlie Howorth

Charles L. Howorth

cc: Hon. Sara Kyle, Chairman
Hon. Deborah Taylor Tate, Director
Hon. Pat Miller, Director

BELLSOUTH'S RESPONSE TO MCI'S LETTER DATED OCTOBER 17, 2002

First and foremost, BellSouth is NOT attempting to eliminate the availability of the combination of the local loop and switching. BellSouth has provided evidence as part of the FCC's Triennial UNE Review that CLECs can, and have, deployed their own switches and thus, in those areas, are not impaired without the provision of TELRIC rated local switching. Competitive switch deployment clearly has occurred in all urban areas, i.e. in the top 100 MSAs. The combination of the local loop and switching would continue to be available to CLECs everywhere. In areas with switching alternatives available to the CLEC, the switching portion of the UNE platform would simply be made available at a non-TELRIC price. In other words, in areas where a CLEC has an alternative to BellSouth switching, BellSouth should not continue to be obligated to offer switching at prices which differ from the market price. Elimination of the requirement to provide TELRIC rated unbundled local switching in areas where there are clearly other switching alternatives available fosters the future expansion of facilities-based competition.

It is imperative to remember that the goal of the Telecommunications Act of 1996 was to create the environment for local competition, not to create local competition, and certainly not to discourage competitors from investing in the local telecommunications market. Although seemingly subtle, this is a huge distinction. Use of the TELRIC rated UNE-P by some CLECs has increased substantially. The TELRIC rated UNE-P has stimulated competition that is subsidized by the ILECs. It is an indisputable fact that UNE-P is simply resale of BellSouth's retail service at a drastic discount, thereby guaranteeing the CLEC a substantial profit without the need to invest in any facilities of its own. It allows a CLEC to target only high-margin customers, thereby significantly reducing the ILEC's revenues without a commensurate reduction in costs. This situation results in an obvious chilling effect on future capital investments not only by BellSouth, but also by all facilities-based CLECs.

BellSouth has consistently argued that UNE-P at TELRIC rates provides CLECs with a disproportionate, risk-free return by allowing CLECs to enter and remain in the local market with little or no risk, and with no incentive to deploy their own facilities. Indeed, there are significant margins available for CLECs in Tennessee by leasing UNE-Ps to serve their customers:

	Residence	Business
Retail Revenue[1]	$35.00	$64.59
State-wide average UNE-P rate[2]	$19.04	$19.04
CLEC Margin[3]	**$15.96**	**$45.55**
% CLEC Margin	**46%**	**71%**

BellSouth is not alone in its contention that TELRIC rated UNE-P is simply resale of retail service at a much deeper discount, which discourages capital investment by CLECs. According to one telecommunications analyst, "UNEP is physically similar to resale. In each case the CLEC uses the ILEC network to provide service to the end-user and essentially limits its own functions to marketing, inputting the order into the ILEC's systems, and billing."[4] Another analyst writes that "[t]he UNE platform is growing rapidly in use. To the CLEC the only difference between reselling and UNEs is the cost. In fact, UNE is nothing more than resale with 2-3x the discount, which comes to a 35%-60% discount."[5] Further, "[w]hen a CLEC uses UNEs INSTEAD of building out its own copper loops, switches, etc., it avoids major capital expense, and 'rides' the RBOCs' investments made over decades."[6] Another analyst notes that "[l]onger-term, the current UNE-P framework is unsustainable. There is no way that the RBOCs in a capital intensive industry with the high fixed costs can afford to sell their key input of production to their competitors at a steep discount and survive."[7]

In its letter, MCI represents UNE-P as "the only vehicle for consumer and small business local competition." Interestingly, MCI has told state commissions that "WorldCom uses state-of-the-art equipment and design principles based on technology available today. Their [MCI's] local network has been built within the past few years using optical fiber rings with SONET transmission, <u>which makes it</u>

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[1] Typical customer targeted by CLECs – for residence equals Complete Choice and for business equals average business local revenue. Both include Subscriber Line Charge (SLC).

[2] Consists of TELRIC rates for UNE-P loop, UNE-P port, local usage based on FCC characteristics and features, where applicable.

[3] The margins are even higher in Zone 1, which are typically the metropolitan areas. For residence, the average profit margin in Zone 1 is $18.97 or 54%. For business, the average profit margin in Zone 1 is $48.56 or 75%.

[4] Anna-Maria Kovacs, PhD, <u>Status & Implications of UNE-Platform In Regional Bell Markets</u>, Commerce Capital Markets, pg. 2.

[5] Bruce J. Robert and William P. Carrier, <u>UNE-P: the Un-Profit</u>, Dresdner Klienwort Wasserstein, pg. 6.

[6] Id. pg. 2.

[7] Timothy Horan, CFA, <u>RBOCs Weak Yesterday on UNE-P Concerns</u>, CIBC Data*Times*, Wednesday, August 21,2002.

possible to access and serve a large geographic area from a single switch."[8] [emphasis added]. MCI made this statement while arguing that MCI should receive the tandem switching rate because MCI's single switch covered a geographic area comparable to the area served by a BellSouth tandem switch. Given that MCI can provide its own switching in such large areas, why should BellSouth continue to be obligated to provide TELRIC rated local switching?

As envisioned by Congress, there are facilities-based CLECs that are successfully competing in Tennessee on an equal footing with the ILECs. In fact, much of that facilities-based competition emerged prior to the UNE-P being used to any significant extent. Now that MCI and some other CLECs are using UNE-P almost exclusively, minimal growth in facilities-based competition is likely to occur. In the long run, innovations that would normally occur from increased investment in the telecommunications network will fail to materialize, and ultimately it is the consumers that will suffer.

Given the lengthy discussion above relative to the pricing issues surrounding the provision of wholesale facilities, it is important to note that retail pricing issues also play a role in the future of the competitive landscape. The introduction of competition into the local market without first changing the existing retail pricing structure has resulted in a significant amount of "artificial" local competition. CLECs choose to serve the most profitable customers who are the very ones that provide universal service subsidies. Competitive choices are primarily available to high-revenue residential customers, businesses, and states with greater population density. Thus, the ILECs are left to serve more of the costly (i.e., geographically dispersed) and lower paying line base. Indeed, the deep discounts for UNEs in conjunction with current retail pricing creates a significant dilemma that is clearly understood within the industry. BellSouth has experienced intense competition in the urban and business markets for its more profitable customers, and much less competition in the rural areas where retail rates have been kept artificially low. Geographic deaveraging of UNE rates without comparable deaveraging of retail prices only exacerbated the problem by reducing competitors' costs to serve the more profitable urban customers. For example, the Zone 1 UNE-P rate is $16.03,[9] and the retail rate for a 1FB in Rate Group (RG) 5 is $39.70 (a positive margin of $23.67). Conversely, the Zone 3 UNE-P rate is $32.72,[10] and the retail rate for a 1FB in RG 1 is $27.05 (a negative margin of $5.67). These relationships plainly show why competition would be stronger in the urban areas than in the rural areas.

[8] *See* Prefiled Testimony of Ronald Martinez in North Carolina Docket No. P-474, Sub 10, dated April 6, 2000, at p. 60; also *See* Prefiled Rebuttal Testimony of Don Price in Georgia Docket No. 11901-U, dated August 3, 2000, at p. 48; also *See* Prefiled Rebuttal Testimony of Don Price in Florida Docket No. 000649-TP, dated September 7, 2000, at p. 45.
[9] Consists of UNE-P loop, port and average usage.
[10] Consists of UNE-P loop, port and average usage.

Clearly, there are a number of serious policy issues facing regulators all across the nation. State regulators, as well as federal regulators, continue to have huge roles to play in shaping the future of our industry. It is essential that all the facts underlying these issues be aired. While it is important for competitive vehicles to be available, it is equally important to ensure that network elements are priced in such a way as to ensure that all players are on an equal footing.