

Presuming bill and keep is rejected, as it must be, the notice asks whether there is a readily available proxy that could be used by state commissions to benchmark the reasonableness of reciprocal compensation rates. NPRM at ¶ 234. As discussed above, given the wide variations in the industry, any fixed proxy is problematic and must allow for individual variations. Nonetheless, it may be possible to derive a proxy for a presumptively lawful reciprocal compensation rate from existing access charges. According to the Commission, for example, the national average charge for switched access is approximately 1 cent per minute (once the CCLC and RIC are deducted), plus an additional 2 tenths of a cent per minute for tandem switching and transport when a call terminates at an access tandem. See Bill and Keep NPRM at n.83. These rates were initially established based upon regulatorily prescribed costs, and have been subject in most cases to price caps for over 5 years. NPRM at ¶ 234. As a result, any reciprocal compensation rate that is set at or below these levels should be presumed lawful, without a further showing.

These numbers also answer an additional question raised by the notice: Whether the reciprocal compensation rates paid by competing carriers to one another must be symmetrical in every instance, by which the notice apparently means “the same.” NPRM at ¶ 235. There is one instance in which the answer is clearly no. The reciprocal compensation rate for calls delivered to an access tandem -- for which the terminating carrier will incur the cost of tandem switching and transport -- should be allowed to be higher than for calls delivered to an end office -- which do not incur those additional costs. MFS Intelenet, Case No. 8584, Phase II, Order No. 72348 (Dec. 28, 1995) at 31. This would allow LECs to more accurately reflect their underlying cost structure. And by permitting an originating carrier to obtain a lower rate by opting to deliver

traffic at the end office as traffic volumes grow, it would also provide correct economic incentives to make efficient use of the terminating carriers network, and thereby help to avoid inefficient overloading of tandem switches.

X. **The Commission Should Not Adopt Resale Rules that Inhibit Negotiations or Preempt State Authority Over Resale**

As with the other parts of section 251, the resale provision relies upon negotiations between the parties, and state arbitrations where negotiations fail. In order to allow this process to work as Congress intended, the Commission should limit any regulations it adopts to implement the resale provision to the following general guidelines.

A. **Discounts Should be Based Upon Net Avoided Costs; Avoided Retail Costs Should Be Offset by Costs to Provide Wholesale Services**

The Commission has correctly noted that avoided costs should be determined on a “net” basis. Any marketing, billing, collection, and similar costs that are associated with offering retail services should therefore be “offset by any portion of those expenses that [LECs] incur in the provision of wholesale services.” NPRM at ¶ 180. This conclusion is sound because a LEC providing retail telecommunications services to resellers must incur costs to market, bill and collect for those services.

Because wholesale services may be provided in several different ways, moreover, the expenses associated with doing so will likely vary across resellers. For example, high volume resellers may order wholesale service through electronic interfaces while other resellers may rely on manual processes, such as telephone calls and faxes. The Commission’s guidelines should therefore allow the parties to negotiate the costs of providing wholesale services as either

a reduction to wholesale discounts or as separate charges. They should not attempt to prescribe a cookie cutter formula for setting wholesale rates.

B. State Commissions Must Be Permitted to Impose Reasonable Class of Service Restrictions

The Act preserves the authority of states to “prohibit a reseller that obtains at wholesale rates a telecommunications service that is available at retail only to a category of subscribers from offering such service to a different category of subscribers.” 47 U.S.C. § 251(c)(4)(B). As an example of a reasonable resale restriction, the Commission correctly states that Congress never intended to allow competing carriers to purchase a service offered at subsidized prices to a specified category of subscribers and then resell it to customers that are not eligible for the subsidized service. NPRM at ¶ 176. The Commission’s guidelines should therefore preserve state authority to impose reasonable class of service restrictions.

Preempting state authority to impose such restrictions, on the other hand, would place LECs at a severe competitive disadvantage and undermine their existing rate structures. For example, business rates generally are higher than residential rates for comparable services in order to subsidize these latter customers. If services could be purchased at wholesale residential rates and resold to business customers, the LEC’s higher business rates would no longer be competitive and the public policy basis for separate residential and business retail rates would be undermined.

C. Wholesale Pricing Obligations Do Not Apply to Discount and Promotional Offerings

Any Commission guidelines should make clear that the obligation to offer services for resale at wholesale rates extends only to the incumbent LEC’s standard retail

offerings. The purpose of the Act's resale provisions is simply to make sure "meaningful resale opportunities are available for competition in the local exchange." See H.R. Rep. No. 204, 104th Cong., 1st Session at 72 (1995). This purpose is met through resale of standard retail offerings at wholesale rates.

In contrast, extending the resale obligation to require wholesale rates for discounted and promotional offerings would inhibit, rather than promote, competition. In order to compete effectively in the local exchange marketplace, LECs need the same ability to attract and retain retail customers through discounts and promotional offerings as their local exchange competitors. LECs' competitors can fashion their competitive discounts and promotions without any obligation to disclose them or make them available to the incumbent or to other competitors at wholesale rates. LECs' should likewise be able to offer discounts and promotional without disclosing them to their competitors and making them available at wholesale rates. Otherwise, they will have little incentive to create these procompetitive discounts and promotions in the first place. Hausman Aff. at 14.

D. LECs Should Be Allowed, but Not Required, to Vary the Percentage Wholesale Across Different Services

The suggestion in the notice that incumbent LECs should be allowed to vary the percentage wholesale discount across different services is a sound one. NPRM at ¶¶ 182-83. This flexibility will enhance resale negotiations between the parties and create more meaningful opportunities for local exchange competition.

The Commission should not, however, take the next step and mandate variations in discount rates across different services. Existing billing systems may be limited in their ability

to handle wholesale rates on a service-by-service basis in the short term.¹⁵ To avoid delaying resale arrangements, the Commission should leave this issue to the negotiation and arbitration process.

XI. Duty to Negotiate in Good Faith

In its examination of each party's statutory obligation "to negotiate in good faith" under the Act, the notice asks whether the Commission should establish national guidelines on what constitutes good faith negotiations. NPRM at ¶ 47. The short answer is that there is no need. In Bell Atlantic's case, negotiations with potential entrants who are interested in actually entering the local market to compete are going well, and substantial progress has been made. Any intervention in the process by regulators runs the risk of encouraging posturing by the parties, and can only serve to delay the completion of negotiated agreements.

A. The Concept of Good Faith is Well Established

As the Commission itself has pointed out a determination of whether a party is violating its duty to bargain in good faith requires careful examination of the facts specific to each case. See Amendment to the Commission's Rules Regarding a Plan for Sharing Microwave Relocation Costs, First Report & Order, WT Docket No. 95-157 (rel. Apr. 30, 1996) at 11. In addition, there exists ample case law dealing with good faith bargaining. These cases are generally in the field of labor law, and arise out of the statutory obligation for employers and representatives of employees to bargain in good faith with respect to, *inter alia*, "the negotiation of an agreement." National Labor Relations Act, 29 U.S.C. §§ 151, 158(d). Indeed, the Commission itself has dealt implicitly with the issue of good faith negotiations in its application

¹⁵ The California PUC recently found similar limitations in LEC billing systems. See Decision 96-03-020, Dockets R-05-04-043, I-95-04-044 (Cal P.U.C. Mar. 13, 1996) at 23-24.

of its “program access” rules despite the lack of explicit guidelines on the subject. In a decision just last year, the Commission found that a cable programmer in effect failed to negotiate in good faith by unreasonably refusing to sell its programming to a requesting cable operator, notwithstanding the fact that the record showed a course of communications between the parties. Cellularvision of New York, L.P. v. SportsChannel Associates, 10 FCC Rcd 9273 (1995). In reaching such a decision, the Commission engaged in the kind of fact-sensitive analysis that should apply toward alleged violations of the good faith requirement contained in Sections 251 and 252.

B. Nondisclosure Agreements Facilitate Negotiations Toward an Agreement

The Commission’s notice also points out that one party has alleged that a request for a nondisclosure agreement in and of itself evidences a lack of good faith on the part of the requesting party. NPRM at ¶ 47. That allegation is wrong. First, even by that party’s own admission, “no ILEC has yet required the signing of such an agreement as a condition for negotiations...”¹⁶ As a result, any nondisclosure agreements that have been concluded to date have been entered into voluntarily on the part of both parties.

Second, the use of nondisclosure agreements is commonplace in settings where parties need to share proprietary information. They are particularly appropriate in situations such as here where the negotiating parties are also actual or prospective competitors. In this respect, a reasonable nondisclosure agreement that imposes reciprocal obligations on the parties not to use the other party’s information for purposes other than to negotiate and/or arbitrate an interconnection agreement under Section 252 actually facilitates efforts to reach agreement. It

¹⁶ See Letter from Richard J. Metzger, General Counsel of the Association for Local Telecommunications Services (ALTS), to Reed E. Hundt, Chairman, FCC (March 25, 1996) at 3.

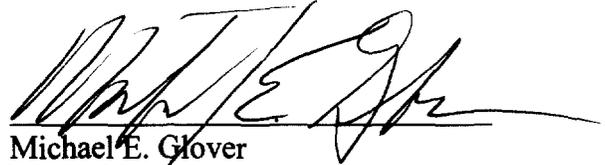
does so by ensuring that the information cannot be misused to obtain a competitive advantage or otherwise used against a party to the negotiations in another context. This is especially true when the negotiating parties are currently (or soon might be) in litigation over the same issues. Quite simply, the parties are less likely to make compromise proposals that deviate from their litigation positions if they fear that their proposals will be used against them in litigation should negotiations fail. It is for exactly this reason that the common law recognizes an evidentiary privilege for settlement discussions. Thus, common sense and business realities dictate that a prudent and well intentioned party would request, and accept, restrictions on each party's use of the other party's sensitive information.

Ironically, while ALTS complains about what is on its face is a reasonable business practice, in Bell Atlantic's experience, it has been a very limited number of potential interconnectors who have adopted practices that do not appear to satisfy the good faith standard. To cite just a few examples, some parties have: submitted a request to begin negotiations in order to start the arbitration clock running but never responded to offers to schedule actual negotiating sessions; requested negotiations for jurisdictions where they admit they have no plans to provide service; or requested interconnection arrangements that they have no bona fide interest in actually purchasing. As a result, contrary to the suggestion of ALTS, the only potential examples of bad faith witnessed to date have been exhibited by a very limited number of potential interconnectors -- not by incumbent LECs.

CONCLUSION

The commission should adopt rules consistent with the foregoing.

Respectfully submitted,



Michael E. Glover

Leslie A. Vial

James G. Pachulski

Lydia Pulley

1320 North Court House Road

8th Floor

Arlington, Virginia 22201

(703) 974-2944

Attorneys for Bell Atlantic

Edward D. Young, III
Of Counsel

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competitor inefficiently to use an existing network rather than build its own competing facilities.

3. Numerous regulatory distortions and other economic factors weigh strongly against applying long-run incremental pricing to interconnection and network elements. For a single-product firm in a competitive market free of regulatory distortions, economic theory recommends prices based on long-run incremental cost. LECs, however, are multi-product firms with economies of scale and scope that result in joint and common costs arising from network investment. These costs need to be recovered for a LEC to continue to make efficient investments in its network and to stay in business. TSLRIC (or LRIC) does not permit these costs to be recovered in an economically efficient manner. LECs also have historical costs due to past network investments. Technological change will deprive LECs of recovering costs if rates are always measured on the basis of a forward-looking optimal network model. Yet a policy setting rates on that basis would create incentives for LECs to underinvest. Productive efficiency requires that embedded costs of efficient investment in the network be recovered by the LECs.

4. Until federal and state regulatory distortions, and subsidization of services created to serve regulatory policy objectives, are eliminated, it would be inappropriate regulatory policy and incorrect economics to price interconnection at TSLRIC or LRIC because of the significant regulatory arbitrage which would be created and because a significant source of contribution to fixed and common costs would not be replaced by an alternative source. Even then, no firm will be totally free of joint and common costs; therefore it would not be appropriate for the Commission to mandate pricing at TSLRIC or LRIC. Also, the "reasonable profit" allowed by the 1996 Telecommunications Act (1996 Act) will not be possible if interconnection prices are set at LRIC or TSLRIC.

5. The same principles dictate that reciprocal compensation arrangements for transport and termination must cover the costs of providing those services. Policies that may lead to underrecovery, such as bill and keep, lead to market failure and economic inefficiency.

6. The "avoided-cost" standard for establishing wholesale prices under the Act is economically efficient. Avoided costs should be measured as the additional costs of providing a service at retail assuming the service is already being provided at wholesale. That is to say, the wholesale price should be set at the retail price, less avoided costs, plus costs incurred in wholesaling the service. The efficient discount for wholesale prices is thus net avoided cost.

II. The Pricing of Interconnection, Network Elements, and Transport and Termination

7. For an unregulated, single-product firm, economic theory holds that efficient prices should be based on long-run incremental cost. Interconnection, network elements, and transport and termination are intermediate goods. If the price for an intermediate good (or input of production) exceeds its cost, the user of the intermediate good will tend to shift to a lower-priced, but potentially higher-cost, input. Because economic efficiency requires that the lowest cost input be used, society's resources will be wasted. This loss of productive efficiency is an aspect of the overall loss in economic efficiency that occurs if rates are not set at incremental cost.

8. However, numerous regulatory distortions and other economic factors recommend against applying this incremental-cost rule to interconnection pricing. Most importantly, LECs are multi-product firms with economies of scale and scope that result in joint, common and embedded costs arising from shared

facilities and network investment. These costs need to be recovered for a LEC to continue to invest in its network.

9. Current regulatory policy does not permit these costs to be recovered in an economically efficient manner. Current regulation creates large economic distortions because the prices of many services are not related to underlying costs and demand factors in an economically efficient manner. In addition, different types of service providers, e.g. IXC's, ESP's, wireless, are each subject to different regulatory and pricing rules for interconnection. Market forces alone do not determine the prices or terms and conditions for any of them. State and federal regulation of the different services create additional regulatory distortions that complicate cost recovery. Given such regulatory distortions and subsidies, setting interconnection at long run incremental cost would create significant regulatory arbitrage and would cause a further shortfall in cost recovery by eliminating a critical source of contribution to fixed and common costs that would not be replaced by an alternative source.

A. Contribution to Fixed and Common Costs

10. It is universally recognized among economists that if all prices are set at TSLRIC or LRIC, LEC total costs will not be recovered because of fixed and common costs which arise from network economies of scale and scope.¹ These costs include historical costs of network investment and the costs of shared facilities or inputs that are not captured in the measurement of LRIC or TSLRIC for a particular service. Thus, the LECs still need a contribution source to cover fixed and common network costs. Only rates that reflect total costs will provide proper

¹ Fixed and common costs are typically estimated at about 50% or more of total LEC costs, or revenue requirements.

cost-based signals.²

11. Prices that reflect costs are important not only for demand-side efficiency, but for productive efficiency as well. If prices do not cover the costs of network investment, LECs will have an incentive to underinvest to avoid the risk of again being unable to recover historic costs. Similarly, if LECs do not recover all of their joint and common costs, they have an incentive to use technology with reduced economies of scale and scope but higher per-unit (in case of LRIC) or per-service (in case of TSLRIC) costs because the latter costs will be more fully captured by prices set at incremental cost. This action may be rational for the firm but it raises social costs and deprives society of productive efficiencies. This principle of productive economic efficiency is universally recognized among economists and the Commission has recognized its importance previously. Cost based prices are necessary so that both the seller and the buyer of a service will make the economically efficient choice.

12. With prices set at appropriate levels to reflect total costs, LECs will have the correct economic incentives to invest in network capacity and upgrades. However, if prices for interconnection, network elements and transport and termination are set too low, CLECs, IXCs, CAPs and CMRS providers would be permitted to free ride off the investment made in existing networks by LECs and by other carriers. This free riding will create perverse incentives for future investment in telecommunications networks. Free riding occurs when one party uses an investment by another party without paying for it. LECs

² Economic analysis demonstrates that one should tax final goods and services, not intermediate goods. Taxation of final goods leads to the economically efficient outcome. However, since the 1996 Act does not consider taxation of final services, interconnection prices can include a mark-up over costs in the rates for different types of interconnection, so as to provide contribution for fixed and common costs.

have invested billions of dollars in their existing networks. If prices do not take account of those economic costs, an incentive will be created for the new CLEC entrant to minimize its cost while taking advantage of the existing networks and not paying for usage. Such market failure will cause future underinvestment in networks because companies will understand that they will not be able to recover their economic costs.

13. Thus, LRIC or TSLRIC may provide a starting point for calculating regulatorily mandated interconnection prices but, because LECs must cover their joint, common and historical costs as well, incremental costs cannot be a ceiling for those rates. No economic basis exists for the Commission to issue a rule restricting interconnection prices to LRIC (or TSLRIC).³ Just as a firm which produces DRAMs marks up its price above LRIC to cover its R&D and fixed and common costs, a LEC must be allowed to mark up its costs. Lacking comprehensive reform of the system of subsidies which now exists in telecommunication, LECs must have the opportunity to earn a sufficient return to their investment to create economic incentives for further investment. Interconnection prices which contain a markup above LRIC give LECs the opportunity to earn this return.

B. The Reasonable Profit Standard of the 1996 Act

14. A further consideration is that interconnection rates set at LRIC, or at TSLRIC, do not include the "reasonable profit" which the 1996 Act permits. Two economic reasons lead to this conclusion. First, telecommunications equipment prices have been decreasing so that LRIC or TSLRIC, which is forward looking, will lead to a lower cost estimate than the actual costs incurred by a

³ In competitive situations LECs may voluntarily lower rates to LRIC to meet competition. LRIC is a valid floor for competitive rates because it allows marginal-cost recovery but not predation.

LEC in building its network.⁴ If LRIC or TSLRIC is used, a reasonable profit will not be earned by the LEC. Instead, an economic loss will be incurred by the LEC because it will not recover the cost of its investment. The NPRM recognizes this problem when it states that "setting the price of discrete services and elements equal to the forward-looking LRIC of each service or element is not likely to recover the historical costs of incumbent LECs' networks." (§ 144) If the Commission, through its regulatory policy, causes LECs to lose money on economically efficient investment, it will discourage future investment and contravene the explicit language of the 1996 Act which states it is designed "to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans."⁵

15. The second reason that the "reasonable profit" requirement would not be satisfied is that some of the costs of the network will be fixed and sunk, even within the forward looking horizon of a LRIC study. These sunk costs will not be counted in the forward looking costs of a LRIC study, but they

⁴ Even if actual historical network investment decisions were always completely efficient at the time they were made, improvements in technology will always guarantee that a totally new, hypothetical, network will have a theoretical lower cost than the actual network in place (or otherwise the older technology could be used in the hypothetical network). Thus, basing cost on the current most efficient technology will impart a downward bias on estimates of actual network costs, causing an economic loss to the LECs which made the historical investment. Thus, the study method proposed by Hatfield and Assoc. (March 1996, submitted on behalf of MCI) which claims that the existing network is "irrelevant" (p. 16) is incorrect as a matter of economics and would lead to a downward biased estimate of LEC costs. In a competitive market situation, a potential entrant could choose a new technology, but if the potential entrant decides not to enter, the hypothetical costs do not enter the pricing decisions. Thus, MCI can decide to invest in a network, but otherwise, the actual costs should be used to set prices, not hypothetical costs.

⁵ Economic theory has focussed recently on the problem of "time consistency" in government policy. If the government (or regulators) confiscate private investment through taxation (or low mandated rates), the market will build this risk into higher discount rates which will lead to decreased future investment. Causing an economic loss on efficient investment through regulatory policy is a form of confiscation by the FCC.

are again investments incurred by the LEC in building its network. Failure to account for these sunk costs will again lead to the outcome that the LEC will not earn a "reasonable profit", but instead will face an economic loss and face inefficient investment incentives

16. The NPRM's proposal that a transitional pricing mechanism could be set at short-run marginal costs (§ 132) directly contravenes sound economic principles. Short-run marginal costs do not account for the cost of capital at all. Thus, short-run marginal costs would not cover the joint, common, and historical costs of providing the service, let alone yield a "reasonable profit". The use of a marginal cost standard would be equivalent to a forced monetary transfer from the LECs to their competitors. Such a transfer would reduce economic efficiency and is inconsistent with the obligation of regulators to allow a regulated company the opportunity to cover its costs, including a return on capital invested.⁶

C. The Use of Proxy Variables to Set Rates

17. Measurement of costs, no matter how defined, is in my experience labor intensive, time consuming, and contentious. The NPRM raises the possibility of using proxy variables to set rates (§ 134). The idea provides significant potential benefits because transaction costs are likely to be much lower if the Commission provides a safe harbor that both parties know is

⁶ To an economist, profits are measured as revenues minus costs. Costs include wages, material, and the cost of capital. To achieve the "reasonable profit" allowed by the 1996 Act, a markup above LRIC is required to help cover the fixed and common costs of the network which are not included in LRIC or TSLRIC. Indeed, regulation of LECs has often considered profit, also often called contribution, as the difference between revenue and embedded cost. Thus, the "reasonable profit" criterion of the 1996 Act is consistent with past regulation of LECs, because without profit to pay for the joint and common costs, LECs would go out of business because the total revenues would be below their total costs on a company-wide basis.

acceptable.⁷ Assuming that IXCs are barred from arbitraging around current access rates, current interstate access rates net of CCLC and RIC, as proposed in the NPRM (¶ 139), provide a reasonable proxy variable for use of the local loop by true local entrants. Since the CCLC is a non-traffic-sensitive charge, the remainder after subtracting CCLC and RIC from access charges would provide a proxy variable for usage-sensitive charges such as the charge for transport and termination under a reciprocal compensation arrangement.

18. Lastly, with regard to unbundled elements specifically, the "technically feasible" standard of the 1996 Act should be subject to a market-test rule. The unbundled element should only be required to be provided when there is actual market demand for its use. (NPRM ¶ 74-81) If LECs are required to provide all unbundled elements initially, and no market demand arises for some of the unbundled elements, the cost of unbundling those elements will have created economic waste and a loss of economic efficiency. Thus, a market test provides the correct standard for the LECs' obligation to provide a given unbundled element.

D. A Bill and Keep Policy Leads to Market Failure and Economic Inefficiency

19. Bill and Keep destroys the correct economic incentives because it makes interconnection "free", i.e. zero price, to the CLEC provider. Thus, the CLEC has no economic incentive to use the least cost, most economically efficient, alternative for transport and termination and the LEC has no incentive to make efficient production or investment decisions. The CLEC provider will choose the least cost alternative to itself, but this alternative may create large costs for the interconnecting LEC

⁷ The use of the HHI standards in the DOJ and FTC Horizontal Merger Guidelines (April 1992) to provide a safe harbor for prospective mergers provides an important cost saving for parties considering a merger or acquisition.

and for society.⁸ Only if cost based prices are used for interconnection instead of free interconnection does a CLEC have an economic incentive to consider the LEC's costs through the price signal it receives. Even if traffic is in balance, cost structures of networks vary and different marketing and investment decisions would cause traffic to fall out of balance over time. Bill and keep will waste social resources, which is among the worst possible outcomes of government policy.

20. Bill and keep cannot be justified on grounds that the costs involved are small or that billing costs exceed the revenues involved. The costs at stake are not small in the aggregate, and whether to bill or not should be left to the LECs, which will make the correct, market-driven decision for themselves. The Commission is also incorrect that bill and keep will only cause "a small loss in economic efficiency if the demand for calls is inelastic with respect to termination charges." (§ 241-242). This argument wrongly considers only allocative economic efficiency. However, the other type of economic efficiency, which is typically more important, is productive economic efficiency. Because bill and keep does not create incentives for CLECs to choose cost-minimizing actions regarding interconnection, it leads to productive inefficiency. Productive efficiency losses are typically large. Thus, the NPRM wrongly looks only at demand-side efficiency and misses the more important supply-side factor of productive efficiency.

⁸ Professor Brock makes an error in his economic reasoning when he claims that an advantage of Bill and Keep is that each company has an incentive to reduce its costs. (G. Brock, "Interconnection and Mutual Compensation with Partial Competition", undated, p. 13) He forgets to take account of the additional cost that the sender of traffic imposes on the receiver of the traffic by its cost minimizing policy. This additional cost creates the externality which leads to the market failure and the loss in economic efficiency. Thus, Professor Brock fails to account for the externality aspect of networks which is an essential feature of networks as economists have long realized.

III. The Relationship Between Wholesale and Retail Prices

21. The 1996 Act in Section 252(d)(3) uses an avoided-cost standard to establish the difference between wholesale rates and retail rates. The avoided cost standard is the correct economic standard because it corresponds to the economic concept of cost causation. Thus, avoided costs should be measured as the additional costs of providing the retail service given that the wholesale service is already being provided.

A. The Avoided Cost Standard Leads to Productive Efficiency

22. The avoided costs standard ensures productive economic efficiency. If the difference between wholesale and retail costs were set at an amount greater than avoided costs, a less efficient competitor than the LEC could compete successfully in providing retail services even though its costs were higher than the LEC. The result would be a decrease in economic efficiency because inefficient providers would enter the market and waste society's resources. On the other hand, if the difference between wholesale and retail costs were set at an amount less than avoided costs, a more efficient competitor than the LEC might not be able to compete successfully, even though its costs to provide the retail component of the service were lower than the LEC. Again, the result would be a decrease in productive efficiency and a waste of resources. Thus, the avoided cost standard provides the correct economic relationship between wholesale and retail prices.

23. To ensure the productive economic efficiency discussed above, the correct measurement methodology is net avoided cost.⁹ Thus, if additional costs are incurred to offer a service at

⁹ Overhead is not an avoided cost because a firm continues to incur overhead expenses when its output changes, by definition. Thus, any allocation of overhead would be inconsistent with the avoided cost standard of the 1996 Act. (NPRM ¶ 180)

wholesale, those additional costs should be subtracted from the measure of avoided costs; i.e., the additional costs should be added to the retail rate before the LEC's avoided costs are subtracted from it.¹⁰ If net avoided costs were not used, and the additional costs were ignored, a less efficient competitor than the LEC could compete successfully in providing retail services even though its costs were higher than the LEC's. The result would be a decrease in productive economic efficiency and a waste of society's resources because the new competitor would not be bearing all the economic costs it was causing. The result would be an externality against the LEC, which would have to bear the additional costs. The externality would cause a market failure that would reduce competition and cause higher prices to consumers.

24. Some LEC services are currently priced below LRIC because of regulation. (NPRM ¶ 185-186) In this situation wholesale rates set below retail rates will cause economic inefficiency. Where retail price is cost-based, the net-avoided-cost rule will result in a wholesale price that properly reflects the LEC's relative cost of providing the service, and the competitor will receive the proper price signal to make an efficient choice between producing a service itself or reselling one that it buys at wholesale. If, however, the retail price of the service is below cost because of regulation, the wholesale price no longer conveys the proper signal and competitors will have an incentive to buy at wholesale even when they are more efficient producers of the service than the LECs are.

¹⁰ This equivalency follows easily from the definitions. Let R be the retail price and A be the LEC avoided costs. The wholesale rate $W1 = R - A$. Let the additional costs be denoted as D. Now the correct wholesale rate would be $W2 = R - (A - D) = (R + D) - A$. Similar equivalencies arise in determining imputation rules for LECs. See J. Hausman and T. Tardiff, "Efficient Local Exchange Competition", Antitrust Bulletin, 1995, and J. Hausman, "Proliferation of Networks in Telecommunications", ed. D. Alexander and W. Sichel, Networks, Infrastructure, and the New Task for Regulation (Univ. of Michigan Press, 1995).

25. If the Commission does require wholesale discounting of services with below-cost retail rates, then the shortfall to the LEC should be made up from the universal services fund or some other source. The fund contribution should of course flow to the party absorbing the loss, which is the LEC providing the service at wholesale. Otherwise LECs will fail to recover their costs leading to the skewed investment decisions and productive inefficiencies already discussed.

B. Wholesale Pricing Should Apply Only to Actual Retail Services

26. Suppose a competitor wants to provide a given retail service that is a vertical service with a contribution contained in its price. This contribution goes to pay for part of the fixed and common costs of the network. Using the methodology described in the 1996 Act and discussed above, the wholesale price would be determined by subtracting the LEC's avoided costs in providing the service on a wholesale basis. Alternatively, to provide the same service the competition could seek to buy a basic dialtone line at its below-cost price, then buy unbundled services at cost, and offer the vertical service to the customer without bearing all the costs of producing that service. The competitor will choose the latter option, if it is allowed, because the cost basis will be lower. The basis of this regulatory arbitrage is the below cost pricing of certain services due to regulation. The Commission should not allow such arbitrage to occur and should not give competitors the option to bypass wholesale pricing by reassembling retail services through purchase of unbundled network elements.

27. The above arbitrage problem arises from the system of subsidies currently built into regulated service prices. As competition increases, regulators will be required to eliminate the subsidies and allow competition to proceed on the basis of

relative economic efficiency. In the near term, however, restriction of wholesale pricing to actual retail services and a prohibition on reassembly of such retail services through unbundled elements will need to be enforced. Otherwise competitors will choose to use below-cost services to compete with LECs who are forced to bear the actual economic costs. Such an outcome would lead to massive economic inefficiency.

C. The Wholesale Discount Should Not Apply to Promotions

28. Companies in competitive markets run promotions to gain new customers. Promotions are a normal pro-competitive activity which benefits consumers. However, if a company receives no economic benefit from a promotion, it will not engage in promotions. The NPRM asks whether the wholesale discount should apply to promotions. (¶ 175) It should not apply because it will deter LECs from offering promotions and competition will be decreased. This prediction is not hypothetical because the California PUC required a retail margin between wholesale and retail cellular rates that included promotions. California was the only state to require a retail margin. As my academic research and affidavits to the Commission on cellular regulation demonstrated, this retail margin requirement led to higher cellular rates in California, even after controlling for other economic factors. Since the 1996 Act makes competition the key standard of future telecommunications policy, the Commission should not institute regulation which will decrease competition. Promotions are a key factor in competition in most competitive markets. They will serve a similar pro-competitive purpose in LEC retail service markets.

J. A. Hausman 13 May 1996
Jerry A. Hausman

Subscribed and sworn to before me
this 13th day of May, 1996

Paula Gaudin

Notary Public

My Commission Expires July 3, 1997

