that there is a bottleneck in the local exchange or that LECs have exclusive control over market share.

77. It was reported that alternative local exchange carriers have over 500 networks that either are operational or under construction, serving over 600 communities, and were expected to have more than 100 competitive switches in operation by the first quarter of 1996, with substantial further growth during the remainder of 1996.[51] In addition, at least 333 central offices, serving more than 45 percent of access traffic, have implemented colocation since 1993.[52] Alternative local exchange carriers include competitive access providers operating fiber optic networks in most of the major cities.

78. In analyzing facilities-based competition, it is important also to include wireless networks, both cellular and personal communications services (PCS). These networks provide local exchange access, both originating and terminating. These networks are economic substitutes for wireline networks. As prices fall for wireless service, these networks increasingly constrain the pricing of wireline services and thus further contradict the view that there is a local bottleneck. It is reported that, using a combination of digital cellular and PCS, "AT&T could begin offering local connections as early as late this year."[53] AT&T already has seven million customers in 320 cities, holds licenses covering areas with 217 million people, and plans to acquire more licenses.[54] Sprint Corp. is deploying a PCS network in sixty-five cities.[55]

2. Competition Based on Unbundled Network Elements

79. Competition based on an entrant's use of unbundled network elements is not a distant dream, but is instead in full swing as envisioned by the Telecommunications Act of 1996. According to the USTA Competition Report of February 10, 1997, there were an estimated 470 final interconnection agreements with another 218 in arbitration. Substantial progress has occurred in identifying the issues to

51. *ALTS Members Plan for Massive Growth; Focus Shifts to Marketing, Partnering Opportunities*, TELECOMMUNICATIONS REP., Nov. 6, 1995, at 1.

52. USTA Price Cap Filing (Dec. 11, 1995).

53. *Vaulting the Walls with Wireless*, BUS. WK., Jan. 20, 1997, at 85.

54. *Id.* at 88.

55. *Id.* at 85.

be addressed in the agreements, establishing prices, and formulating the applicable adapting federal and state regulation. Entrants are combining UNEs with their existing and planned facilities.

3. Competitors Are Not in Their "Nascency"

80. For Professors Baumol, Ordover, and Willig to suggest that the entrants into local telephony are "in their nascency"[56] is to overlook the identity of these competitors. AT&T is hardly a newcomer to telecommunications. Moreover, it is constructing a national wireless network, having paid $11.5 billion in stock for McCaw Cellular.[57] AT&T reportedly plans to use its own switching equipment in combination with unbundled local loop facilities leased from other local exchange providers.[58] AT&T has a well-established customer base, a strong national brand identity, and serves over 100 million presubscribed lines.

81. MCI is also a seasoned competitor in telecommunications. It is entering local telephony through its subsidiary, MCI Metro, which will construct facilities to serve the business market and later the residential market.[59] In addition, MCI has entered into an agreement with Nextwave Telecomm Inc., a PCS provider that bid $4.7 billion in the FCC's auctions to acquire wireless licenses for the provision of service covering areas with 110 million people.[60] MCI is considering offering the PCS services "as an alternative to regular local telephone service."[61] Finally, as a result of its pending merger with British Telecom, MCI will have a substantial infusion of cash with which to fund its expansion into local telephony.[62]

82. Sprint Corp. is the ninth largest local exchange company, with 6,730,468 access lines and operating revenues of over $3.8 billion.[63] Sprint has joint venture agreements with the cable companies

56. Baumol-Ordover-Willig Affidavit at 5 ¶ 9.
57. Andrew Kupfer, *AT&T's $12 Billion Cellular Dream*, FORTUNE, Dec. 12, 1994, at 100.
58. Catherine Arnst, *AT&T: Will the Bad News Ever End?*, BUS. WK., Oct. 7, 1996, at 122, 128.
59. *MCI Widens Local Effort*, N.Y. TIMES, Dec. 12, 1994, at C5.
60. Lawrence W. Fisher, *MCI Joins Nextwave in Wireless Communications Venture*, N.Y. TIMES, Aug. 27, 1996, at C3.
61. *Id.*
62. *A Marriage of Convenience*, THE ECONOMIST, Nov. 9, 1996, at 71.
63. UNITED STATES TELEPHONE ASSOCIATION, PHONE FACTS 1996, at 8 (data for 1995).

that control Teleport Communications Group (including Brooks Fiber Properties, McLeod, and ICG Communications).[64]

83. WorldCom Inc. has bought the largest competitive access provider, MFS Communications, for approximately $12 billion.[65] WorldCom is thus a fully vertically integrated local exchange and long-distance carrier, that already has local exchange facilities in 45 major metropolitan areas.

84. Clearly, concerns over the "nascency" of entrants into the local exchange are misplaced. The relative levels of experience and abilities of these carriers cannot be viewed as a barrier to their entry into the local exchange. To the contrary, their capacities are evidence of the vigor of the competition in the local exchange that already is in progress.

B. The Janus Artifice: Inconsistency in Pricing and Evaluating Competition

85. The Romans built temples to Janus, the most ancient king who reigned in Italy, who was often represented with two faces because he was believed to know the past and the future.[66] Like Janus, the interexchange carriers alternate between past and future perspectives on markets as it serves their purpose. The result is an inconsistent economic analysis of competition and pricing. When evaluating the prospects for competition, the IXCs look to the past, emphasizing the sunk costs of the LECs and past market share. For pricing purposes, the IXCs look to the future, promoting their notion of forward-looking costs. We have already emphasized the fallacies inherent in the forward-looking cost approach. Those problems are compounded by shifts in perspective that are meant to facilitate desired policy outcomes. At a minimum, the Commission should apply its yardstick in a consistent manner.[67]

86. When evaluating the LECs' costs for pricing purposes, the Commission suggests

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64. E. S. Browning, *WorldCom Deal Gives "Local Access" a Buzz*, WALL ST. J., Aug. 27, 1996, at C1.

65. Mark Landler, *WorldCom to Buy MFS for $12 Billion, Creating a Phone Giant*, N.Y. TIMES, Aug. 27, 1996, at C1.

66. LEMPRIÈRE'S CLASSICAL DICTIONARY OF PROPER NAMES MENTIONED IN ANCIENT AUTHORS WRIT LARGE 304 (1788) (F. A. Wright ed., Routledge & Kegan Paul 3d ed. 1984).

67. Children know the Janus Artifice as the Pushmi-Pullyu Phenomenon, named for "the rarest animal of all," "now extinct," that "had no tail, but a head at each end." HUGH LOFTING, THE STORY OF DR. DOOLITTLE 73 (1920) (Bantam Doubleday Dell Publishing Group, Inc. 1988). The pushmi-pullyu was very difficult to catch "because, no matter which way you came toward him, he was always facing you." *Id.*

employing "the most efficient network architecture, sizing, technology, and operating decisions that are operationally feasible and currently available to the industry."[68] As we have emphasized, such an approach is not the way competition works because it does not reflect, as market prices do, the costs of companies in the industry. For the purposes of price regulation, the Commission should rely on the studies of the actual costs of the LECs rather than speculative costs.

87. Measuring costs based on the most efficient network architecture would suggest that the Commission believes that entry by efficient competitors building entirely new networks with the best design and features is not only imminent, but in progress. One would expect the Commission's competitive analysis to mirror that assumption, with entry by efficient competitors being viewed as a feature of the competitive landscape. Yet, the interexchange carriers view such entry as an unlikely and distant prospect. Similarly, the Commission proposes competitive triggers to adjust regulation slowly until competition takes place. Doubtful that facilities-based competition is even feasible, the Commission bases its competitive triggers on implementation of network interconnection and UNE-based competition.

88. If the Commission's market analysis leads it to believe that facilities-based entry is unlikely to occur for years, it cannot avoid using the LECs' actual costs of providing access for the purpose of regulating the price of access. As we have already emphasized, basing a cost analysis on the costs that firms actually incur in the marketplace is the right approach in any case, because in competitive markets prices reflect the costs of existing firms, including competitive entrants. If the Commission believes that facilities-based entry is a reality, as we too believe, then it should move rapidly to grant the LECs pricing flexibility and freedom from unnecessary incumbent burdens that hinder their competition with entrants in the local exchange.

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68. *First Report and Order* ¶ 683.

C. A Market-based Approach to Access Pricing Requires Less Reliance on Regulation Than a Prescriptive Approach

89. The IXCs criticize the Commission's proposed market-based approach and argue for increased regulation under the prescriptive approach. AT&T argues for more access price regulation based on its view that UNE competition will not provide an alternative to access "in the foreseeable future."[69] Such a perspective contradicts the intent of the 1996 Act and ignores the efforts of the Commission, the state regulatory commissions, and telecommunications carriers involved in negotiating and implementing interconnection agreements. Despite AT&T's criticisms, UNE competition does provide competitive alternatives that supplement already active facilities-based competition in the local exchange. AT&T further believes that a market-based approach to access pricing would create social costs because it believes that the regulated rates of the incumbent LECs are excessive. Thus, AT&T expresses its reservations about the effectiveness of state and federal rate regulation while it calls for even more regulation. AT&T's mistrust of market forces is evident but misguided. As we have already emphasized, competition in the local exchange, both facilities-based and UNE-based is significant and can be relied upon to determine efficient prices for access services.

1. The Prescriptive Approach Would Yield Outcomes That Would Differ from a Competitive Market

90. In recommending the prescriptive approach, AT&T again raises the natural monopoly question to suggest that competition in the local exchange is speculative: "[A]s yet there is not even a definitive basis for rejecting the views of many experts that some exchange access and local exchange markets may be natural monopolies."[70] Although one of the authors of this reply affidavit is flattered to be cited by AT&T as an "expert" in this regard,[71] the citation is out of context. In his textbook, *Regulation and Markets*, Daniel F. Spulber writes on the page immediately following the pages cited

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69. Comments of AT&T Corp. at 44.

70. *Id.*

71. *Id.* at 44 n.70 (citing DANIEL F. SPULBER, REGULATION AND MARKETS 3-4 (MIT Press 1989)).

approvingly by AT&T, "Merely asserting that technology exhibits natural monopoly will not demonstrate the need for regulatory intervention."[72] Moreover, he continues:

> It should be emphasized that the market conditions associated with sunk costs and natural monopoly need not be permanent. The natural monopoly characteristics of a regulated firm's technology may be eliminated through demand shifts or technological change.[73]

Evidence indicates that the local exchange no longer exhibits the characteristics of natural monopoly, if indeed such a description applied in the past.[74] AT&T further overlooks the testimony of its *own* expert economic witnesses in recent state arbitration proceedings arguing that local telephony is *not* a natural monopoly.[75] In short, while the Telecommunications Act of 1996 recognized the market and technological changes in the industry and accelerated the process of deregulation, AT&T's arguments for reregulation are inexplicably oblivious to those changes

91. The Competitive Telecommunications Association (CompTel) argues that access rates will not move to TSLRIC absent a prescriptive approach to access reform.[76] In justifying this conclusion, CompTel raises a number of arguments. First, CompTel makes the oft-repeated assertion that callers do not make the terminating access choice. This concern is misplaced. As we have pointed out in our initial comments, the cost of the terminating access choice is taken into account in competitive markets by

72. SPULBER, *supra* note 71, at 5

73. *Id.* at 608.

74. *See* Spulber, *supra* note 49.

75. DAVID L. KASERMAN, JOHN W. MAYO, MICHAEL A. CREW, NICHOLAS ECONOMIDES, GLENN R. HUBBARD, PAUL R. KLEINDORFER & CARLOS MARTINS-FILHO, LOCAL COMPETITION ISSUES AND THE TELECOMMUNICATIONS ACT OF 1996, at 12 & n.11 (July 15, 1996) [hereinafter KASERMAN REPORT] (prepared for AT&T Corp.) (citing Richard T. Shin & John S. Ying, *Unnatural Monopolies in Local Telephone*, 23 RAND J. ECON. 171 (1992)); Testimony of David L. Kaserman, In the Matter of AT&T Communications of the Midwest, Inc.'s Petition for Arbitration with Contel of Minnesota, Inc., Pursuant to Section 252(b) of the Federal Telecommunications Act of 1996, OAH Dkt. No. 9-2500-10733-2, MPUC Dkt. Nos. P-442, 407, M-96-939, at vol. 4B, Tr. 111 (Minn. Office of Admin. Hearings/Minn. Pub. Util. Comm'n, Oct. 22, 1996) ("Shin and Ying . . . found that [local telephony is] not a natural monopoly . . . ."). The Shin-Ying study cited by Professor Kaserman used data from 1976 to 1983 and found that LEC costs were not subadditive before the AT&T divestiture. In subsequent empirical research, Professor Ying similarly concluded that over the periods 1976-83 and 1984-91, LECs were not natural monopolies. Affidavit of John S. Ying, Motion of Bell Atlantic Corp., BellSouth Corp., NYNEX Corp., and Southwestern Bell Corp. to Vacate the Decree, United States *v.* Western Elec. Co., No. 82-0192 (D.D.C. filed July 6, 1994). Previous studies of natural monopoly conducted on the Bell System reached conflicting results. *Compare* Laurits R. Christensen, Diane C. Cummings & Philip E. Schoech, *Econometric Estimation of Scale Economies in Telecommunications*, in ECONOMIC ANALYSIS OF TELECOMMUNICATIONS (Léon Courville, Alain de Fontenay & Rodney Dobell, eds., North-Holland 1983) (AT&T had scale economies) *with* David S. Evans & James J. Heckman, *A Test for Subadditivity of the Cost Function with an Application to the Bell System*, 74 AM. ECON. REV. 615 (1984) (AT&T's costs were not subadditive).

76. Comments of the Competitive Telecommunications Association at 13-14

customers involved in repeated communications and by carriers in their service offerings to final customers.[77] Second, CompTel believes that price pressures on retail service do not translate into pressures on access charges. Here, CompTel fails to understand that competitive pressures can drive down input costs as well. Moreover, competition for access serves to bring down prices for access. Third, CompTel questions whether there is competition for switched transport, even though they acknowledge that "competitive carriers today provide high-capacity dedicated interoffice transport, and so provide at least some downward pressure on direct-trunked transport rates."[78] Competitors need not provide every product variant for prices to be constrained. Competition for high-capacity dedicated interoffice transport certainly provides sufficient reason for access charges to be constrained by competition. Moreover, with unbundled network elements available, the prices of switching and other services are constrained by the prices of UNEs. Thus, CompTel is misguided to conclude that regulation of transport and of terminating and originating access is required on the grounds that market forces are insufficient.

92. CompTel is correct in its supposition, however, that market prices will not equal TSLRIC. The reason is that market prices do not necessarily equal TSLRIC—that is, attributable average costs—because prices allow firms to recover their total economic costs, including the joint and common costs of supplying goods and services. CompTel, in its call for the Commission to implement the prescriptive approach, seeks an outcome that the market need not, *and should not*, provide.

93. CompTel supports a "reverse Ramsey" approach to access pricing. It seeks to lower access charges to TSLRIC "for those access elements that are least subject to competitive market forces" and to maintain access charges at current levels for those access rate elements that may be subject to competition.[79] One can only be puzzled at the purpose of such a prescription, unless it is to deny incumbent LECs any return on the sale of access, since they would incur losses in all of their markets

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77. Affidavit of J. Gregory Sidak and Daniel F. Spulber at 12–13 ¶ 30.
78. Comments of Competitive Telecommunications Association at 15.
79. *Id.* at 17.

as a result of such a pricing policy. Under reverse Ramsey pricing of access, as suggested by CompTel, the incumbent LECs would not sell any access in the overpriced portion, where current rates would be maintained, and the LEC would make losses on the continued sales of access in other areas, where regulators had forced prices to TSLRIC. That outcome would be the opposite of pricing flexibility. It is a recipe for disaster. Access reform means adjusting prices in reaction to market forces, not in opposition to them.

2. Geographic Deaveraging

94. Observation of incumbent LECs confirms that costs differ across geographic areas because the average costs of serving high-density population areas are lower than the average costs of serving low-density areas. Moreover, high-density population areas generally have a higher concentration of business customers, which leads to higher average revenues in comparison with areas of low population density. Broadly speaking, the average net revenues per line are greater in urban areas. Through geographic averaging, regulation has created cross-subsidies from urban to rural customers. There are also regulatory cross-subsidies from business to residential customers. As a consequence, in the initial phase of competition, it should not be surprising that competition is more intense in urban areas than rural areas, because entrants pursue higher-margin customers. Similarly, in its initial phase, competition for business customers has been more intense that competition for residential customers. As competition has developed, it has expanded geographically and has now expanded to competition for residential customers.

95. The key to enhanced competition is rebalancing rates through geographic deaveraging, allowing prices to rise in higher-cost areas and to fall in lower-cost areas, through the forces of competition. The recommendations of the Ad Hoc Telecommunications Users Committee (Ad Hoc) are just the opposite. Ad Hoc would lower prices in those areas where competition is not present. It suggests that "the proposal in the *Notice*—to require TSLRIC price levels for monopoly access services where

competition is not present—would properly replicate the results of competitive markets."[80] Ad Hoc reasons:

> In the present drive to establish a competitive marketplace for access service (which Ad Hoc fully supports), the Commission cannot abandon the primary goal of economic regulation—to ensure that prices charged by regulated firms operating in noncompetitive markets emulate the prices that would be charged in a competitive marketplace.[81]

To the contrary, the best way to "replicate" or "emulate" the results of competitive markets is to decontrol prices and entry and to allow competition to continue to expand. As we showed in our initial affidavit, there is substantial competition in the provision of access services. Removing regulatory controls, including eliminating geographic averaging, will allow this process to continue.[82] The Commission should resist exhortations to return to increased regulatory intervention, and it should refrain from adopting the proposed prescriptive approach.

3. Tests for Competition in the Local Exchange

96. In evaluating competition in the local exchange, the Commission should not create new "tests" of competition or delay the process of granting incumbent LECs the opportunity to compete in the full array of telecommunications markets. Although consideration of demand and supply elasticities and evaluation of barriers to entry may be relevant, market share data are not necessarily informative. As we explain in greater detail below, a high market share by a regulated firm formerly protected by entry controls and subject to price controls does not indicate market power, although substantial losses in market share as entry occurs are a good indicator that market power is not present. The relationship between prices and price caps need not be an accurate indicator of market power because the relationship depends on how the cap was set initially and how it is adjusted. That said, given the requirements of the 1996 Act, the Commission should apply standard tests (as employed in antitrust law) for evaluating the competitiveness of local exchange markets.

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80. Comments of the Ad Hoc Telecommunications Users Committee at 38.

81. *Id.* at 42.

82. Affidavit of J. Gregory Sidak and Daniel F. Spulber at 8–9 ¶ 23, 11 ¶ 28.

97. In addition, the Commission has some readily available benchmarks. RBOCs must pass the checklist proceedings to be granted authority to supply interLATA services. An RBOC receiving such authority clearly should not be subject to additional tests beyond the checklist. The checklist proceedings themselves should not be used as a means of further delaying grants of access pricing flexibility. The state authorization of interconnection agreements should provide sufficient evidence that UNE competition is in progress.

98. Although AT&T argues that it is premature for the Commission to find local exchange markets competitive, MCI goes AT&T one better when it observes that "it is premature to establish the criteria for evaluating the competition faced by incumbent LECs."[83] This is the equivalent of a perpetual moving target. There should not be any delay in establishing the criteria for evaluating competition. Moreover, if, as MCI asserts, the criteria cannot now be established, then how would we know when it *is* time to design such criteria? Perhaps MCI is suggesting that there be criteria for determining when it is time to devise criteria for evaluating competition

99. MCI criticizes the Commission's market-based approach on the grounds that competition takes time to develop. MCI notes that a "market-based approach to access reform ignores the time it will take and the financial realities faced by new entrants as they try to enter the local market."[84] To the contrary, a market-based approach allows prices and service offerings to adjust to competition as entry occurs, without regulatory attempts to determine the rate and direction of change. MCI makes clear that "even with multiple means of market entry, a new entrant will not be able to enter all places at once."[85] Nor would they be expected to. AT&T, MCI, and other entrants will select those portions of the market that they find to be most profitable. Extension of regulatory controls, without pricing flexibility for incumbents, would only perpetuate existing opportunities for entrants to "cherry pick" parts of the market

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83. Comments of MCI Communications Corp. at 66.
84. *Id.* at 42.
85. *Id.*

where competition heretofore has been reduced by regulation.

100. MCI is concerned that, because competition begins in areas with the greatest concentration of traffic, under the Commission's market-based approach "consumers that local competition has not yet reached will remain subject to the continuation of unwarranted excessive access charges while they wait for competition to develop."[86] Such concerns do not provide a foundation for a prescriptive regulatory approach that drastically reduces access charges across the board. Continuation of price caps eliminates cost shifting through access charges while allowing the incumbent LECs to meet competition as it develops. Cost recovery for incumbent LECs requires that access charges be supplemented by competitively neutral and nonbypassable charges on users of interstate access to recover the full cost of providing them access to the local exchange network

101. MCI suggests that reducing access prices would eliminate funds that would be used to "cross-subsidize LEC entry into the competitive long-distance business."[87] The underlying assertion that incumbent LECs wish to subsidize their entry into long-distance ignores economic and business realities. LECs wish to enter the long-distance business because it would be profitable for them to do so. Moreover, customers demand the convenience of one-stop-shopping, so that all carriers have an incentive to offer a bundle of services to consumers. No company would add a service if the incremental returns from that service did not cover the incremental costs. MCI's argument that LEC entry into long-distance would not be profitable implies that LECs wish to lose money by adding this service offering. LECs seek to enter into long-distance markets because it is in their economic interest to do so. MCI's fear that LECs wish to enter simply to lose money is not well founded. Moreover, MCI's notion that the LECs should be deprived of cost recovery in access would seem to apply generally, even applying to revenues generated by "new business."[88] Following MCI's logic, the LECs should be made to suffer losses for

86. *Id.* at 43.
87. *Id.* at 14.
88. *Id.* at 13.

as many of their services as possible to eliminate internally generated funds that might be used to compete with MCI in long-distance markets. MCI's objective appears to be avoidance of competition rather than avoidance of irrational cross-subsidies. The Commission should rest assured that LECs, like any other business, will enter only market segments that are profitable and will have no incentive to cross-subsidize between lines of business. Cross-subsidies are features of regulated rate structures that are untenable in competitive markets.

D. "Reinitialization" of Price Caps Is Simply Opportunistic Behavior by Regulators and Free Riding by Competitors

102. The proposal to "reinitialize" price caps is a thinly-disguised means of lowering access charges by regulatory fiat rather than competition. The motivation of AT&T, MCI, and other entrants in calling for reinitialization is evident as well—they seek to obtain access below economic costs so as to free-ride on the incumbent LEC network. If the Commission were to accede to these demands to subsidize entrants, it would engage in regulatory opportunism—that is, it would take advantage of the reliance of incumbent LECs on the Commission's earlier regulatory commitments to price caps.

1. Regulatory Opportunism

103. What are the consequences of regulatory opportunism (self-interest seeking with guile) carried out through price-cap reinitialization? The incentive effects of future price-cap regulations are reduced because the incumbent firm understands that regulators and competitors will seek to profit from its efforts at cost reductions through increased efficiency and capital investment aimed at lowering operating costs. The incumbent firm that passes on these cost reductions through price cuts will be subject to regulators reneging on price-cap agreements and ratcheting down the caps. Such actions cannot be covered up simply by invoking "reinitialization" or some other euphemism.

104. MCI's economic witness, Professor John E. Kwoka, Jr., criticizes price caps on the grounds that regulators might behave opportunistically and that the regulated firm might anticipate their actions. Professor Kwoka states:

> Since cost efficiency is the primary motivation for most price cap plans, it is useful to note at the outset that the desirable efficiency properties emerge unambiguously only under specific conditions. Notably among these are myopic profit maximization by the firm and credible commitment to nonintervention by the regulator. If the regulated firm adopts an intertemporal view as opposed to single-period profit maximization, it may choose some degree of cost inefficiency today in order to secure a more profitable capped price in the future.[89]

Therefore, regulators are urged to behave opportunistically, on the grounds that they cannot be trusted anyway. When Professor Kwoka states that the regulated firm "adopts an intertemporal view," he does not mean that the firm maximizes the present discounted stream of future profits, as indeed it should do. Rather, he means that the regulated firm anticipates the regulator's unilateral abrogation of its price-cap commitments. Thus, price caps do not work, he concludes, because their incentive effects have been harmed by regulatory opportunism. And, since price caps do not work, why not repudiate existing agreements and "reinitialize" right now?

105. Thus regulators are urged to break the regulatory contract because it would be naive to trust regulatory commissions. MCI, on the basis on Professor Kwoka's analysis, observes that

> in actual practice nothing in price caps in any fashion alters the firm's incentives to maximize its private profitability at the expense of social objectives (*e.g.*, cost minimization, product innovation, and cost-based pricing).[90]

MCI's perverse line of reasoning is as follows: Because regulators cannot be trusted, price caps do not work, and hence the Commission should feel free to go back on its existing price-cap regulation. Reinitializing is OK, because everyone knew that you would do it anyway.

106. The analysis of MCI and Professor Kwoka also is incorrect with regard to incentives for cost minimization. Companies regulated with price caps have enhanced incentives for cost efficiency relative to rate-of-return regulation, even taking into account the credibility of regulatory commitments. To the extent that prices are decoupled from cost measurements, companies have added incentives to

89. Professor John E. Kwoka, Jr., Statement on LEC Price Cap Reform, at 4, *attached to* Comments of MCI Communications Corp.

90. Comments of MCI Communications Corp. at 46.

devote efforts to reducing costs through operating efficiency, innovation, and cost-reducing capital investment.[91] When properly administered, price caps provide benefits relative to rate-of-return regulation because the regulated firm has an incentive to lower prices through innovation and investment. Moreover, when properly administered, price caps allow firms pricing flexibility to respond to competition. Finally, when properly administered, price caps reduce regulatory cross-subsidies because firms have economic incentives to rebalance rates. These benefits are indeed significantly reduced or eliminated by the downward ratcheting of the kind that AT&T, MCI, and others recommend. Although MCI's recommendations show the potential pitfalls of price-cap regulatory commitments, they do not imply that the Commission should "reinitialize" access prices. The effect of doing so would be to reduce the benefits from price-cap regulation. Given the market alternatives available for access, the best course is to remove price controls altogether, rather than to increase price regulation through "reinitialization."

2. Uncertainty and Competition: Price Caps versus Incumbent Handicaps

107. MCI argues for a cut in access charges and increased regulatory intervention, seeking to replace the supposed chaos of the marketplace with the certainties of regulation. In seeking "reinitialization" of price caps, MCI camouflages its desire for subsidized entry by suggesting that price caps lead to "unpredictability of prices," which is "disruptive to consumers seeking nothing more than low-cost service and to competitors and new entrants alike striving to make rational investment decisions."[92] There is little question that markets involve increased uncertainty relative to a rate-of-return regulated regime. In a competitive market, prices respond to changes in demand, costs, technology, and other factors. The difficulty in predicting changes in the underlying economic conditions is precisely why prices should be set by market forces rather than regulatory control. To argue that markets provide greater certainty for consumers and entrants such as MCI ignores the efficiencies and benefits from market

91. *See* DAVID E. M. SAPPINGTON & DENNIS L. WEISMAN, DESIGNING INCENTIVE REGULATION FOR THE TELECOMMUNICATIONS INDUSTRY (MIT Press & AEI Press 1996).

92. Comments of MCI Communications Corp. at 46.

competition, and the inefficiencies in a regulated regime. The vagaries of competition provide little justification for delaying the opening of telecommunications markets as envisioned in the 1996 Act.

108. MCI seeks more than lower access charges, however. Its proposals are aimed at handicapping incumbent LECs and thus placing them at a competitive disadvantage relative to entrants. MCI elaborates on this theme: "Since prices are no longer tied to costs or any other benchmark, the dominant firm may set and change prices for any reason it chooses (*e.g.*, market perceptions, strategies, etc.)."[93] MCI is suggesting that, under price caps, prices are no longer "tied to costs" only in the sense that they are no longer tied to costs *through regulatory controls*. The suggestion that price caps free prices from cost considerations is incorrect, of course. Companies take into account their costs in making supply decisions. Companies continue to have an incentive to lower their costs to increase their operating returns. Moreover, price caps allow companies greater flexibility in adjusting prices to competition and other changes in market conditions.

109. What concerns MCI is that incumbent LECs can price competitively by reducing prices in competition with entrants. MCI is concerned that incumbents will respond to customer demand (what MCI calls "market perceptions") and to competitors' actions (what MCI calls "strategies"). But responses of these sorts are the mechanisms by which competition works. MCI would prefer to tie the hands of incumbents by fixing prices through regulation. That course of action would enhance MCI's competitive position at the expense of incumbent LECs. This is not how competition is supposed to work; rather, it is how entrants benefit from incumbent burdens. "Reinitialization" is a mechanism for MCI to gain an unmerited competitive advantage.

110. Deregulation should allow competition to expand. Deregulation should not create safeguards for specific competitors. MCI's quest for competitive advantage through regulation is evident:

> Given the dangers inherent in premature pricing flexibility under price caps, the Commission should not grant additional pricing flexibility unless there has been a clear

93. *Id.*

> demonstration that existing pricing flexibility is inadequate to respond to the level of actual competition.[94]

This standard for granting price flexibility is even more stringent than the requirement that there be demonstrable competition. MCI goes far beyond the market-based and prescriptive proposals of the Commission. MCI would have the Commission require not only a showing of the presence of competition, but also a showing that pricing flexibility currently is not sufficient to respond to competitors. It would be difficult enough to quantify or even define "adequate" pricing flexibility. But such a test would be particularly unreasonable because the incumbent LEC would have to prove the *absence* of such flexibility

111. Moreover, the incumbent LEC would have to prove the absence of pricing flexibility *after the fact*. In effect, AT&T, MCI, and others would continue on their present course of market entry into local telephony, protected from competition from the incumbent LEC. After entrants had made competitive inroads against an incumbent LEC handicapped by regulation, the incumbent would presumably be invited to show that its pricing inflexibility did not allow it to respond competitively to entrants. Once competitive disadvantages for the incumbent LEC had become a *fait accompli*, perhaps price controls would then be removed. Such a proposal by MCI would extend and perpetuate regulation. It is targeted at preventing incumbents from competing.

112. MCI further defends its proposal for reducing incumbent pricing flexibility by asserting that incumbent LECs "have failed to use their existing pricing flexibility."[95] This questionable proposition presumes that regulators and entrants have a better understanding of the business decisions of incumbent LECs than do the managers of those companies. As Professor Kwoka and MCI observe:

> The essential problem with geographic deaveraging is that it would allow an incumbent LEC to lower access charges in only those markets where it faced competitive entry.[96]

94. *Id.* at 48.
95. *Id.*
96. *Id.* at 57 (citing Kwoka, *supra* note 89, at 21).

The idea of geographic deaveraging (and price flexibility in general) is to allow companies to price according to market forces, including cost and demand considerations. MCI laments that an incumbent LEC may respond by cutting prices in response to competition from competitive access providers and other suppliers of access. Thus, MCI and other entrants may be forced to compete by lowering their prices as well. The complaint expressed in the passage quoted above makes it evident that MCI seeks protection from competition. MCI does not seek unfettered price competition. Rather, MCI wishes to control, by regulatory fiat, when and where prices fall.

3. "Reinitialization" Is Rate-of-Return Regulation Revisited

113. The push for "reinitialization" of price caps is nothing more than a plan to reimpose rate-of-return regulation on incumbent LECs. Under the banner of competition and incentive regulation, commenters favoring this move are instead proposing just the opposite—a retreat to old-fashioned regulation. For example, Ad Hoc appeals for rate-of-return regulation on the following basis:

> Indeed, reinitializing to an 11.25% rate of return (or some newly-determined rate of return level) reinforces the intended mirroring of competitive market efficiencies that the price cap plan is designed to provided.[97]

Thus, imposing prices based on rates of return is somehow characterized as price-cap regulation. Moreover, rate-of-return regulation is also "mirroring" the competitive market. In addition to these implausible assertions, Ad Hoc suggests setting some new rate of return, presumably through a rate hearing. It bears emphasis, however, that rate-of-return regulation is more stringent than price-cap regulation. Moreover, rate-of-return regulation is not at all a "mirror" of competition. Ad Hoc's suggestion that rate-of-return regulation serves such a role is another instance of the doublespeak employed by constituencies that would enlist the Commission to accomplish their corporate objectives administratively.

114. Ad Hoc then likens rate-of-return regulation through "reinitialization" to market entry:

97. Comments of the Ad Hoc Telecommunications Users Committee at 44.

> A reset of the access charge price levels to the authorized rate of return emulates the kind of pricing activity that would be expected in a competitive industry by the introduction of a new, efficient provider into a market that is presently allowing existing providers to earn supra-normal returns.[98]

By arguing for rate-of-return regulation, such reasoning contradicts Congress' purpose in the Telecommunications Act of 1996. It is misleading to characterize such command-and-control pricing as emulating market pricing. Moreover, Ad Hoc fails to recognize the high level of competition that is already present in the marketplace and asserts, incorrectly and without any attempt at factual support, that incumbent LECs are earning "supra-normal returns."

115. Although it recognizes that pricing based on rate-of-return regulation would have negative economic incentives for firms in the industry, Ad Hoc nonetheless characterizes rate-of-return regulation as "economically efficient pricing" and asserts, again without any support, that the benefits from increased regulation "*far* outweigh any negative effects that reinitialization might have in terms of 'dampening' the efficiency incentives of the price caps plan."[99] Ad Hoc would turn back the clock, tighten regulatory controls rather than loosen them, and artificially lower access prices through administrative decree.

116. AT&T argues for "reinitialization" because it is "easier to administer that the 'market-based' approach."[100] Even if that proposition were true, ease of administration does not argue for command-and-control regulation. The social costs of impeding competition and further distorting prices for telecommunications services far outweigh supposed savings in administrative costs. Even with ease of administration, AT&T's recommendation for increased regulation flouts the Telecommunications Act of 1996. Far from favoring forbearance, AT&T urges the Commission to increase regulation because there may be short-run administrative savings in comparison with the removal of pricing regulations. The Commission should resist the temptations of "easy regulation." Moreover, the notion that command-and-

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98. *Id.*
99. *Id.* (emphasis in original).
100. Comments of AT&T Corp. at 22.

control price regulation is "easy" is clearly misguided, as anyone familiar with rate hearings and the apparatus of rate-of-return regulation can attest. Yet AT&T offers a plan for alleviating administrative problems. It suggests that, although some LECs have hundreds of access elements in their traffic-sensitive and trunking baskets, only "four such elements . . . account for virtually all of the revenues."[101] AT&T then finds that "it is not surprising that an almost identically-defined unbundled network element exists for each of the key access elements."[102] AT&T thus recommends pricing those access elements in the same manner that the UNEs are priced. Indeed, AT&T would go further: "UNE rates, if anything, *overstate* access element costs."[103] Presumably, national "proxy" prices should be set by the Commission for those elements. AT&T thus recommends that the flawed approach that the Commission applied in the *First Report and Order* be extended to access pricing, except that even lower costs be attributed to UNEs in the case of interstate access. AT&T would go even further, because it disagrees with the Commission that common costs create revenue deficiency problems in the pricing of access that they do not create in the pricing of UNEs.

117. The Commission should reject AT&T's recommendation for increased regulation. AT&T's objective is transparent: to free-ride on the incumbent LEC's network at below-cost prices. The experience of traditional rate-of-return regulation and the complexity of the *First Report and Order* on interconnection show that AT&T's vision of administrative simplicity is a mirage. AT&T's proposal is a subterfuge to use regulation to obtain favorable prices that are below the economic cost of providing interstate access services. The only way to achieve administrative simplicity is through regulatory forbearance.

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101. *Id.* at 23.
102. *Id.* at 24.
103. *Id.* at 25 (emphasis in original).

III. The Opposing Commenters Distort the Incumbent LEC's Ability and Need to Recover Costs

118. The opposing commenters do not understand what it means for the FCC to give an incumbent LEC the reasonable opportunity to recover its economic costs. AT&T asserts that incumbent LECs "have already recovered, and almost certainly will recover in the future, their legitimately incurred and relevant prior expenditures."[104] That assessment rests on an understatement of the relevant costs and an implausibly optimistic view of the incumbent LEC's ability to recover those costs.

A. The Opposing Commenters Incorrectly Understate the Costs That an Incumbent LEC Is Entitled to Recover

119. AT&T argues that, in five respects, the incumbent LEC "grossly overstates the magnitude of relevant embedded costs."[105] Those five arguments are unpersuasive.

1. "Misallocation" of Investment in Network Enhancement

120. AT&T argues that incumbent LECs have "misallocated" costs to local telephony to "subsidize their non-telephony activities."[106] This supposed misallocation encompasses digital upgrading of the network and investment in central office plant to accommodate increased demand by residential customers for additional lines. AT&T cannot have it both ways. On the one hand, it endorses TELRIC pricing based on a futuristic network architecture; on the other hand, AT&T wants the FCC to second-guess network investments that, in AT&T's view, are not essential to the provision of the bare-bones local telephony. Needless to say, Congress rejected the POTS definition of telephony service by substantially expanding the concept of universal service in the Telecommunications Act of 1996.[107]

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104. *Id.* at 31.
105. *Id.*
106. *Id.*
107. 47 U.S.C. § 254(c)(1) ("Universal service is an evolving level of telecommunications services that the Commission shall establish periodically under this section, taking into account advances in telecommunications and information technologies and services.").

2. Misapprehension of the Effect on the Regulatory Contract of Switching from Rate-of-Return Regulation to Price Caps

121. AT&T argues that any of an incumbent LEC's capital investments made after January 1, 1990, when price cap regulation replaced rate-of-return regulation for interstate access, cannot give rise to underrecovery of costs: "After that date, there could be no legitimate shareholder expectation of guaranteed embedded cost recovery, if there ever was any such expectation."[108] That reasoning is fallacious because it mistakes a modification of one term in the regulatory contract for a termination of that contract.

122. Parties to a contract sometimes modify their agreement and thus supersede the old contract with a new one. With respect to the regulatory contract, modification has occurred when the regulator and the public utility have agreed, through the formality of public rulemakings, to alter a key provision of the contract, such as the manner in which the price of the utility's output is determined and whether the utility's profit level will be regulated along with its price. That modification has taken the form of the transition from cost-of-service, rate-of-return regulation to incentive regulation such as price caps.[109] State legislatures have also participated in some modifications of the regulatory contract by repealing, before Congress's enactment of the Telecommunications Act of 1996, statutes that prohibited competitive entry into regulated services such as local exchange telephony.[110] Some of the new regulatory structures even carry the name "social contract."[111]

123. Changes in regulatory procedures, such as a switch from rate-of-return regulation to a system of price caps do not necessarily represent a termination of the regulatory contract. Generally, such

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108. Comments of AT&T Corp. at 32.

109. *See* SAPPINGTON & WEISMAN, *supra* note 91.

110. *E.g.*, CAL. PUB. UTIL. CODE § 2882.3.

111. Alternative Regulatory Frameworks for Local Exchange Carriers, 33 C.P.U.C.2d 43, 107 P.U.R.4th 1, I.87-11-033 *et al.* (Cal. Pub. Utils. Comm'n 1989); Proposed Policies Governing Restructuring California's Electric Services Industry and Reforming Regulation, R.94-04-031, I.94-04-032, Decision 94-12-027, 151 P.U.R.4th 73 (Cal. Pub. Utils. Comm'n 1994); New England Tel. & Tel. Co., D.P.U. 94-50, 153 P.U.R.4th 355 (Mass. Dep't Pub. Utils. 1994); New England Tel. & Tel. Co., DR 89-010, Order No. 20,149, 123 P.U.R.4th 289 (N.H. Pub. Utils. Comm'n 1991); Comprehensive Review of Telecommunications, Dkt. No. 1997, Order No. 14038, 138 P.U.R.4th 620 (R.I. Pub. Utils. Comm'n 1992).

changes in telecommunications regulation have preserved the regulator's obligation to provide the utility with an opportunity to earn a competitive rate-of-return on its investment.

124. The basic system of price caps often keeps in place other aspects of rate regulation. The regulator continues to control rates through the caps; the utility has price flexibility below the price limit. Price-cap formulas frequently feature sharing rules that require the utility to divide earnings above some threshold amount with its customers. Regulators typically continue to assume responsibility for the financial health of the regulated utility. The basic dimensions of the regulatory contract remain in place if regulators retain the system of entry controls as revenue protection devices and maintain the utility's service obligations.

125. For example, the California Public Utilities Commission (CPUC) included *financial and rate stability* among its goals in establishing its system of incentive regulation for local exchange carriers called the "New Regulatory Framework."[112] The financial stability goal meant that the financial condition of the local telephone exchange carriers should not change markedly under New Regulatory Framework. According to the CPUC: "Stability is an important aspect for any plan. As financial stability promotes rate stability, customers, utilities and other market participants will each benefit from predictable prices for utility services."[113] Despite the use of a price-cap formula for adjusting rates, the CPUC continued extensive monitoring of the regulated companies' financial and operational information, indicating the regulator's continued responsibility for the financial return of the LECs. The CPUC indicated its intent to maintain the utilities' financial returns through *increased* regulation:

> A regulatory structure which combines the price cap indexing approach with a sharing mechanism can provide protection to both shareholders and ratepayers from the risks that the indexing method may over- or under-estimate the revenue changes which are needed to keep the utility financially healthy, but not too healthy. The increased regulatory

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112. As the CPUC defines it, the New Regulatory Framework is an incentive-based regulatory framework "centered around a price cap indexing mechanism with sharing of excess earnings above a benchmark rate of return level." Alternative Regulatory Frameworks for Local Exchange Carriers, 33 C.P.U.C.2d 43, 107 P.U.R.4th 1, I.87-11-033 *et al.*, Decision 89-10-031 (Cal. Pub. Utils. Comm'n 1989).

113. 33 C.P.U.C.2d at 198.

> involvement required to implement and maintain a sharing mechanism is a price we are willing to pay at this time for this added protection.[114]

Thus, the switch to incentive regulation, while maintaining other components of the regulatory contract, represents at most modification, not abandonment, of the contract.

126. Changes in the mechanism of rate adjustment are an administrative procedure instead of a fundamental change in contract terms. Price-cap mechanisms provide incentives for efficiency by allowing utilities to keep some of the gains from cost reductions. Such benefits existed under rate-of-return regulation as a consequence of lags between rate hearings. Price caps confer pricing flexibility that allows the regulated utility to carry out some limited changes to its rate structure, while keeping regulatory control over total revenues. Incentive regulation begins to constitute a fundamental renegotiation of the regulatory contract only when it is coupled with relaxation of entry controls and changes in the utility's obligations to serve.

127. The use of price caps and other forms of incentive regulation does not alter the manner in which damages for breach of the regulatory contract are calculated. The damages should still equal the present value of net revenues. The amount of damages should be adjusted to the extent that the pricing method alters the net revenue expectations of the utility. The relaxation of entry barriers reduces earnings, and competitive opportunities allow for mitigation as before. The formula for calculating damages thus remains the same.

3. Shortened Useful Lives of Depreciable Assets

128. AT&T argues that incumbent LECs' "arguments that underrecoveries have resulted from shortened useful lives and technological displacement ignore the fact that the ILECs have had ample opportunity to seek adjustments to price regulation based upon supported assessments of actual useful remaining lives of relevant local network plant."[115] This argument is fallacious in several respects.

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114. *Id.* at 134.
115. Comments of AT&T Corp. at 32.

First, it ignores that the protracted depreciation schedules in regulated industries function as a kind of bonding mechanism that holds the regulated firm's capital "hostage" over the life of the regulatory contract so as to ensure the regulated firm's satisfactory performance. Obviously, regulators could permit more accelerated depreciation schedules that approximated the useful economic lives of the assets placed in service. But regulators routinely decline to do so. It is therefore disingenuous to suggest today that incumbent LECs previously could have received accelerated depreciation for their network investments if they had simply asked regulators for it.

129. Second, AT&T argues that incumbent LECs "should not be permitted to transform commercial and technological developments that they failed to anticipate into subsidies from consumers."[116] This argument fails to recognize that the risks of commercial and technological change that AT&T would place on the incumbent LEC are endogenous to the regulatory regime, pursuant to which the LEC could recover the cost of its investment only according to allowed depreciation schedules. It is tempting to say that an incumbent LEC failed to anticipate a commercial or technological change as of a certain date and, therefore, must bear the loss for the undepreciated portion of its asset base that becomes stranded at that moment. But that line of reasoning implicitly (and erroneously) assumes that the incumbent LEC voluntarily submitted to a longer depreciation schedule than the true economic life of its assets. The fact that a depreciation shortfall existed at the time of the commercial and technological change is simply another way of saying that the regulator knowingly constrained the LEC's ability to minimize the extent to which its shareholders would be made to bear such risk.

130. Third, AT&T's argument selectively forgets that cost recovery for the investments at issue has been placed in jeopardy by *regulatory* actions of the FCC. In 1992 the Commission's expanded interconnection decision enabled competitive access providers to collocate their fiber-optic networks with

116. *Id.* at 32–33.

local exchange networks to provide interstate telephone service for businesses.[117] The FCC broadened its expanded interconnection decision in 1993.[118] Those Commission actions in effect lifted entry restrictions into key portions of the interstate access market. Financial economists have estimated that the Commission's expanded interconnection decisions reduced the equity value of the seven RBOCs by $14.9 billion.[119] The Commission's May 1991 NPRM on expanded interconnection[120] alone is associated with a $7.8 billion decline in equity value for the RBOCs, which corresponds to cumulative abnormal return of –6.50 percent.[121] It is incorrect to say that this loss in equity value—which would translate directly to a diminished value for the RBOCs' undepreciated local exchange assets—resulted from "commercial" or "technological" changes that the RBOCs failed to anticipate. Rather, it reflected the diminished earning capability of the RBOCs' existing asset base, given the FCC's change in regulatory policy concerning the provision of interstate access by competitive access providers.

4. The Erroneous Reference to the Reproduction Cost of a Technology That Would Not Be Reproduced Is Another Manifestation of the Janus Artifice

131. AT&T argues that "for much of the pre-1990 ILEC plant, forward-looking costs are likely to *exceed* historical costs carried on ILEC books and, thus, there is obviously little risk of underrecovery."[122] AT&T asserts that "new narrowband services and technological developments" in broadband services will "increase the likely value of existing copper cable" such that "current reproduction costs may be *higher* than historical embedded costs."[123] This reasoning is fallacious.

132. It may turn out, as AT&T assumes, that copper plant will be more costly to replace in

117. Expanded Interconnection with Local Telephone Company Facilities; Amendment of the Part 69 Allocation of General Support Facility Costs, Report and Order and Notice of Proposed Rulemaking, CC Dkt. Nos. 91-141, 92-222, 7 F.C.C. Rcd. 7369 (1992).

118. Expanded Interconnection with Local Telephone Company Facilities; Amendment of the Part 69 Allocation of Part 36 of the Commission's Rules and Establishment of a Joint Board, Second Report and Order and Third Notice of Proposed Rulemaking, CC Dkt. Nos. 91-141 (Transport Phase I), 80-286, 8 F.C.C. Rcd. 7374 (1993).

119. Kevin C. Green & Kenneth M. Lehn, *The Effect of Enhanced Competition on the Equity Values of the Regional Bell Operating Companies*, 16 MANAGERIAL & DECISION ECON. 469, 472–74 (1995).

120. Expanded Interconnection with Local Telephone Company Facilities, Notice of Proposed Rulemaking and Notice of Inquiry, CC Dkt. No. 91-141, 6 F.C.C. Rcd. 3259 (1991).

121. Green & Lehn, *supra* note 119, at 473 (z-statistic = -3.01)

122. Comments of AT&T Corp. at 33 (emphasis in original).

123. *Id.* (emphasis in original)