D. It Is Not a Sufficient Response to the Takings Issues Posed by This Proceeding to Say That the Commission Can Address the Problem of Underrecovery of Costs on a Case-by-case Basis Through a Waiver Process

178. The U.S. Constitution, not the Communications Act or the Commission's rules, forbids the uncompensated confiscation of private property for a public purpose. Nonetheless, AT&T argues that, "to the extent the Commission remains concerned about the possibility of future ILEC underrecovery claims, the Commission could easily address that concern with a waiver process that would permit an ILEC to demonstrate, once the commercial consequences of the new competitive regime become apparent, that it was not in fact permitted the opportunity to recover its prudently incurred investment expenses from all revenue sources."[185] Apart from the fact that "all revenue sources" are *not* relevant to the question of recovery of the incumbent LEC's costs, it should be clear that the Commission cannot demote the constitutional protection of property to the status of an administrative hearing for the grant of a waiver from agency rules. If an incumbent LEC has been denied the reasonable opportunity to recover its full economic costs of providing regulated services, its complaint will be filed against the Commission (and states, as the case may be) in federal court. It is therefore mystifying why AT&T would identify, as an example worth emulating here, the waiver process specified in paragraph 739 of the *First Report and Order*, an agency order immediately challenged by incumbent LECs on takings grounds and stayed by the U.S. Court of Appeals for the Eighth Circuit pending that court's decision on the merits.[186]

CONCLUSION

179. The opposition of AT&T, MCI, and other interexchange carriers to market-based pricing of interstate access is not founded on sound economic reasoning. Rather, it represents an attempt to free-ride on the local exchange networks without paying the full costs. By arguing for TELRIC pricing, these companies seek to avoid paying a reasonable share of the joint and common costs of the incumbent LEC's

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185. Comments of AT&T Corp. at 41.
186. *Id.* at 42 & n.68.

network. Like the government's provision of public goods, the incumbent LEC's provision of a local telecommunications network entails common costs that cannot be attributed to individual services or customers and recouped through usage-sensitive prices. If access were to be priced too low, such pricing would send incorrect signals to IXCs and other competitive entrants and would dissuade facilities-based competition, which the Telecommunications Act of 1996 seeks to promote. Conversely, if access were to be priced to high, it would invite uneconomic bypass by facilities-based competition and UNE-based competition. The Commission must strike a balance, a difficult if not impossible administrative task. Fortunately, the solution need not be carried out administratively, contrary to the assertions of opposing commenters. Instead, the Commission should allow the LECs to adjust access prices flexibly in response to market forces. Regulation should sunset as competition continues to grow.

180. Efficient access prices will not necessarily recover the costs incurred by the LECs to discharge their existing and ongoing regulatory obligations. To avoid effecting a taking, the Commission should supplement access prices with competitively neutral and nonbypassable charges on users of interstate access. The Commission should reject proposals to avoid cost recovery. Moreover, the Commission should reject the proposals of AT&T, MCI, and others for pricing *below* efficient levels by "reinitializing" price caps and imposing TELRIC pricing. Such an approach would be neither efficient nor compensatory.

* * *

I hereby swear, under penalty of perjury, that the foregoing is true and correct, to the best of my knowledge and belief.

J. Gregory Sidak

Subscribed and sworn to before me this 13 day of February, 1997.

Notary Public

My Commission expires: _____

* * *

I hereby swear, under penalty of perjury, that the foregoing is true and correct, to the best of my knowledge and belief.

Daniel F. Spulber

Subscribed and sworn to before me this 14th day of February, 1997.

Notary Public

My Commission expires: 9/24/00.

OFFICIAL SEAL
DOUGLAS C. KAMBICH
NOTARY PUBLIC, STATE OF ILLINOIS
MY COMMISSION EXPIRES 09/24/00

ATTACHMENT 3

Economic Aspects of Access Reform: A Reply

Richard Schmalensee and William E. Taylor

National Economic Research Associates

USTA Reply Comments
CC Docket No. 96-262
February 14, 1997

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ECONOMIC ASPECTS OF ACCESS REFORM: A REPLY

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EXECUTIVE SUMMARY

In this paper we reaffirm our initial conclusions contained in our paper entitled "Economic Aspects of Access Reform" and respond to the arguments raised by other parties in this proceeding.[1] Despite these arguments, we maintain that developments in the exchange access market—due to continued technological change and the substitutability of Unbundled Network Elements (UNEs)—will lead to increased competitive pressure for all ILEC customers, thus requiring pricing flexibility immediately in order for efficient market outcomes to prevail. In fact, regardless of the cross-elasticity of demand between UNEs and access, sound economic principles require that unneeded regulatory constraints be removed when the market is *first* opened to competition so that entrants and incumbents will make efficient entry and exit decisions. It is interesting to note that IXCs, who have used such pricing flexibility in their own markets, would deny the ILECs the ability to use similar forms of pricing. Such a strategy is based not on sound economic principles but in a desire to use the regulatory process to gain market advantage.

We also disagree with those parties who argue that Total Element Long Run Incremental Costs (TELRIC) and/or Total Service Long Run Incremental Costs (TSLRIC) are appropriate measures with which to equate access rates and that, rather than relying on market forces to reform access, a prescriptive approach should be used. We urge the Commission to reject this approach and, instead, allow market forces to determine equilibrium rates so as to ensure efficient resource allocation and minimize transactions costs associated with the regulatory process. Arguments that price squeezes will occur to the extent that access levels are above incremental costs are, as described below, without merit and should not sway the Commission from erroneously adopting a non-market based approach.

[1] Richard Schmalensee and William E. Taylor, "Economic Aspects of Access Reform," USTA Comments in CC Docket No. 96-262, January 29, 1997, Attachment 1 (Schmalensee and Taylor).

In addition, we have evaluated a recently-released paper by MCI[2] that purports to indicate that competition has increased in the interstate toll market. Our preliminary analysis, however, indicates that MCI has substantially misrepresented facts in their recitation and ignored important features of the long distance market in its analysis of those markets. We include an attachment which presents a summary of the MCI position and a critique of that position with a more thorough examination of the evidence.

[2] True Competition in the Long-Distance Market, MCI Communications Corp., January 27, 1997.

I. INTRODUCTION

In our paper entitled "Economic Aspects of Access Reform," we argued that in conjunction with technological changes and current market forces, the Telecommunications Act of 1996 ("the 1996 Act") and the Federal Communications Commission (FCC) Interconnection Order[3] accelerate entry into the exchange access markets and thus increase the need for regulatory flexibility.[4] A market-based reform proposal, therefore, is preferred to a prescriptive approach which is a reversal of the incentive-improvement intentions of price cap regulation and likely to confound desirable market outcomes. We concluded that USTA's transition plan for streamlining regulatory constraints is an appropriate mechanism which takes into account the competitive nature of the market when lifting regulatory constraints and provides sufficient protection to prevent the exercise of market power.

In this paper, we reaffirm our initial conclusions and respond to some of the arguments raised by other parties. In particular, we disagree with the assertions that TELRIC and/or TSLRIC are appropriate for pricing exchange access. TELRIC/TSLRIC is only the *directly* attributable part of total economic cost, while the total economic cost of a service or element must include a suitable portion of common (overhead) and shared costs. In addition, while it is appropriate to base prices on forward-looking economic costs, it is crucial that costs be based on the *incumbent's* actual network so as to accurately capture the opportunity costs that society foregoes when elements/services are consumed. This is one of the reasons why a market-based approach is vastly superior to a prescriptive approach which has to *estimate* economic costs rather than relying on market forces to make the determination. In fact, a prescriptive approach is likely to confound desirable market outcomes and have long lasting and deleterious consequences.

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[3] *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996.* CC Docket No. 96-98, First Report and Order, 11 FCC Rcd 15499, 1996 (Interconnection Order).

[4] Schmalensee and Taylor.

Contrary to the claims by other parties, UNEs—as defined and determined in the Interconnection Order—provide an effective substitute to the Part 69 access regime. Under the terms of the Interconnection Order, UNEs may be combined to provide a total exchange access service equivalent to conventional access service—provided that the competitor "wins" the end user. This allows a CLEC, for example, to purchase unbundled loops, local switching, signaling, and transport to provide exchange access.[5] In essence, a competitor need not invest in loops, switches or transport to provide exchange access or local exchange service. We believe that this significantly reduces the absolute level of sunk costs required to enter the industry and makes *all* ILEC customers potential targets.

Arguments regarding the anticompetitive effects of keeping access rates above competitive levels while RBOCs enter the interLATA market are without merit from a theoretical perspective and practical considerations. The structural and nondiscrimination provisions in section 272 provide ample protection against the traditional price squeeze arguments, and there are significant theoretical problems with the non-traditional price squeeze argument as discussed below.

Other parties to this proceeding argue against granting pricing flexibility until *after* competition has been authorized and has taken hold. We believe that it is essential to eliminate unneeded regulatory constraints which do not reward efficiency and prevent the least-cost supplier from providing the service when the market is *first* opened to competitors. This would force entrants and incumbents to make efficient entry and exit decisions, some of which entail large investments and sunk costs. In order for competitors to be given accurate and efficient price signals, they must compete with firms on as symmetric a basis as possible.

USTA's pricing flexibility proposals are consistent with sound economics and are conservative because they call for flexibility *after* competition has been authorized. Pricing

[5]The pricing of unbundled network elements, of course, determines the margin and extent of bypass. The FCC's pricing rules are currently unresolved given the Stay in the 8th circuit. However, a number of states are proceeding to resolve pricing issues under the terms of the Act.

flexibility—such as volume and term discounts and customer-specific prices and service configurations—are normal and healthy consequences of competition in markets where customers have widely different needs for services. Efficiency requires that competitors *and* ILECs be able to respond to rapidly changing and idiosyncratic demands and preferences.

II. TELRIC IS NOT ECONOMIC COST

A. TELRIC/TSLRIC is not appropriate for pricing purposes

Contrary to the claims of Professors Baumol, Ordover and Willig, Total Element Long-Run Incremental Costs (TELRICs) are not the true economic costs of network elements.[6] While forward-looking economic cost is the appropriate basis for pricing, pricing at TELRIC/TSLRIC is inappropriate for a number of reasons and will not accurately capture the real economic costs which are incurred by society in providing services. First, pricing at TELRIC/TSLRIC does not allow a firm to recover its common costs—in the case of TSLRIC, it does not allow recovery of shared costs as well. When economies of scale and scope are present, pricing at incremental costs is insufficient to provide the firm the opportunity to recover all its costs. As discussed in our initial comments, IXCs—who urge the Commission to price access at incremental costs—do not price interLATA toll at incremental costs.[7] Second, basing prices on the TELRIC/TSLRIC of a *hypothetical*, ideally efficient system built by either the incumbent or some other carrier, starting with a blank slate and using the most efficient current technology, fails to represent how real networks are produced and, therefore, biases the cost estimates downward. In addition, TELRIC/TSLRIC pricing fails to recover ongoing costs or burdens asymmetrically borne by ILECs and fails to recover sunk costs taking the form of a return on and of assets whose costs have not yet been fully recovered.

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[6] Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig, Comments of AT&T Corp. in CC Docket No. 96-262, January 29, 1997, Appendix A (Baumol, Ordover and Willig).

[7] Schmalensee and Taylor.

1. TELRIC/TSLRIC is only a starting point for pricing

As recognized by the FCC, setting prices at TELRIC/TSLRIC would not recover all of the economic costs associated with interconnection and network elements.[8] Neither TELRIC nor TSLRIC captures the total economic cost of an element or service. TELRIC/TSLRIC is only the *directly* attributable part of total economic cost, while the total economic cost of a service or element—for setting prices—must include a suitable portion of common (overhead) and shared costs. In view of shared and common cost components in the element's or service's economic cost, the element/service price would generally have to be higher than the TELRIC/TSLRIC per unit.

To understand why this is the case, it is necessary to understand the concepts of economies of scale and economies of scope. Economies of scale arise whenever the cost per unit of a service declines as the quantity provided of that service increases. Economies of scope arise when the combined total cost of providing two or more services is less than the sum of the costs of providing those services separately. While economies of scale arise because of a more intensive and economical use of fixed costs for shared resources at higher levels of supply of a service, economies of scope may arise when multiple services share fixed productive resources or facilities. Both forms of economies result in lower incremental costs.

In the presence of economies of scale and/or scope, incremental cost only defines the *price floor* for a service, i.e., the level below which the price cannot fall. The economically efficient price, however, would typically have to exceed the price floor when there are scale or scope economies. This is because the same fixed costs (service-specific or shared/common) that give rise to the economies of scale and/or scope cannot be recovered fully if service prices are set equal to their respective incremental costs. For the firm in these circumstances to stay viable, it must be able to set prices that, collectively, recover all of its costs. Only prices set in

[8] Interconnection Order ¶694.

excess of TELRIC/TSLRIC can accomplish this. Pricing at TELRIC/TSLRIC will not cover the actual economic costs because shared and common costs would not be recovered.

Therefore, TELRIC/TSLRICs are properly used as a tool to test for cross-subsidy among services produced by an earnings-constrained, multi-product, regulated firm because, by definition, a service is subsidized if its incremental revenue does not cover its incremental cost.[9] It is not, however, appropriate to set prices equal to TELRIC/TSLRIC in light of the economies of scale/scope present in the telecommunications industry.

Finally, pricing at TELRIC/TSLRIC would exclude from recovery ongoing costs or burdens asymmetrically borne by the ILEC but not by competitors by virtue of public utility obligations such as providing basic services at rates below economically efficient levels. The lost revenues from such policy have historically been made up by contributions incorporated in the prices of services such as access, toll, and vertical services such as local usage and custom calling.

2. TELRIC/TSLRIC of the *incumbent's* network is the only relevant cost

While it is appropriate to base prices on forward-looking economic costs, it is crucial that costs be based on the *incumbent's* actual network so as to capture accurately the opportunity costs that society foregoes when elements/services are consumed. Therefore, decisions must be based on *actual* forward-looking expected costs of an efficient entrant—not based on an unrepresentative hypothetical network. The ILECs already have a ubiquitous network serving their entire franchise territories and are providing services to new customers within those territories. The economic purpose of setting prices at forward-looking costs is to inform buyers of the costs that society will *actually* incur or save and only the actual *supplier's*—not a hypothetical supplier's—costs are relevant.

[9] Strictly speaking, in economic theory, the price floor should be simply the LRIC of a service: i.e., the long run cost of the next increment of demand for the service. LRIC expresses the additional cost incurred every time resources are expended to produce an additional increment of service. TSLRIC, on the other hand, measures the cost incurred when the demand increment is the entire service

In a world of changing technology—as is characteristic of telecommunications—firms do not constantly update their facilities in order to completely capture today's lowest-cost technology. This would lead to the absurd result that investments made at time t would instantaneously be outdated at $t+1$, where the interval in question is extremely short. In consequence, such an investment would never earn a return sufficient to justify the investments in the first place. For this reason, firms in competitive industries would practice what is called "anticipatory retardation." adopting the most modern technology only when the progressively declining real costs had fallen sufficiently below currently prevailing prices as to offer them a reasonable expectation of earning a return on those investments over their economic life.[10] Under these circumstances, prices in perfectly competitive markets would not be set based on the current most efficient technology at each period in time. This would only be the case if the investment decision internalized extremely high rates of depreciation—based, of course, on economic life—and cost of money to compensate for higher risks associated with the exposure of the investment to advanced technological change.

B. Estimates of Above-Cost Access Rates are Inaccurate

MCI estimates that current access rates are $11.6 billion in excess of forward-looking economic levels.[11] Such a conclusion is incorrect. MCI incorrectly assumes that forward-looking economic prices are *equal* to the TELRIC/TSLRIC in question. In addition, MCI estimates are based on Hatfield 2.2.2 which calculates the cost of a hypothetical network and contains numerous other deficiencies, some of which may have been addressed in its recent reincarnation as Hatfield Model 3.0.[12]

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[10] William J. Fellner, "The Influence of Market Structure on Technological Progress," American Economic Association, Readings in Industrial Organization and Public Policy, Homewood: Richard D. Irwin, 1958; See also Alfred Kahn, *The Economics of Regulation*, Vol. 1, pp. 199-20, note 91.

[11] MCI Comments in CC Docket No. 96-262, January 29, 1997, p. 23.

[12] *Ibid.*, p. 21.

1. Forward-Looking economic costs do not equal TELRIC/TSLRIC

For a multiproduct firm with substantial fixed costs, incremental cost pricing is unsustainable in the long run and does not allow a firm to recover all of its economic costs of production. By assuming that firms in a competitive environment price at TELRIC/TSLRIC, MCI significantly overestimates the extent to which current access rates are above forward-looking economic costs.

2. TELRIC/TSLRIC estimates based on Hatfield are incorrect

Proxy cost models, such as Hatfield 2.2.2, of local exchange networks based on unrealistic static notions of efficiency fail to adequately capture the correct economic costs facing society and do not provide policymakers with reliable information. Basing prices on costs that no real-world provider could hope to meet is anticompetitive, because it would stifle, not promote, the most effective type of competition: facilities-based. Incremental costs must approximate the *actual* amount of resources that society foregoes—opportunity costs—when it consumes local exchange services. Failure to do so would lead to inefficiencies and provide incorrect market signals.

The assumption that it is appropriate to estimate the cost of a new network designed to minimize the cost of serving a known, constant demand is incorrect. Real ILECs do not face a known, constant demand. Instead, they must provide both for growth and uncertainty in demand, made even more uncertain by the 1996 Act. Real networks are built over time and must constantly change to accommodate changes in demand. Thus, the costs of a real network are higher than the cost of a network that is built instantaneously to serve a "snapshot" level of demand. By simulating population locations and a network to serve them, an unrealistic static model produces a network that is independent of past LEC investment decisions, but it need not resemble the network that an efficient firm would use to serve households and businesses where they actually are located.

In addition, the Hatfield 2.2.2 default assumptions fail to take into account the changing competitive environment by using prescribed regulatory depreciation lives and an unrealistically low cost of capital. Fill factors are inefficiently high and cause costs to be understated by reducing the amount of cable required to serve a given population.

For these reasons, MCI's estimate that current access rates are $11.6 billion above forward-looking economic rates are incorrect. While we do not dispute that current access rates are above competitive levels—due, in part, to past Commission and state policy of maintaining basic rates low—we believe the $11.6 billion estimate far exceeds the actual amount.

C. AT&T's $45 Billion Figure

AT&T implies that the social costs of inflated access charges may be as high as $45 billion per year.[13] Such an implied assertion is wholly unsupported by the facts. This figure is based on Crandall and Waverman's alternative scenarios for total deregulation of the U.S. Telephone Industry.[14] The estimate calculates *net* welfare gains to society—taking into account consumer and producer surplus—of $29.9 billion under a scenario that includes the following: (i) average residential rates of $40/month; (ii) average business rates of $50/month; (iii) long distance rates of $.05/minute *as a result of entry from the LECs* and other companies with lower access rates; and (iv) long distance, residential-access and business-access price elasticities of -0.75, -0.03 and -0.01 respectively.[15]

Under these assumptions changes in consumer surplus and producer surplus equal $44.7 billion and -$14.8 billion respectively. In essence, increased competition in long distance from other carriers—including LECs—*combined* with a significant rate rebalancing to recover non-

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[13] AT&T Comments, p. 3.

[14] Robert W. Crandall and Leonard Waverman, *Talk is Cheap, The Promise of Regulatory Reform in North American Telecommunications*, Table 8-5, The Brookings Institution, Washington, D.C.

[15] According to Crandall and Waverman, in 1993 average residential and business rates were $19 and $42.50 respectively and average interstate toll rates were $.157: *Talk is Cheap*, p. 277-278.

traffic sensitive (NTS) costs from the end user reduce long distance rates to more competitive levels and account for the estimates cited by AT&T. To imply that these figures are related to reductions in carrier access charges, in and of itself, is highly misleading.

D. Stimulation in Access Demand

AT&T states that if access prices were set at long-run incremental costs, the resulting price reduction would likely stimulate a great deal of additional demand for access and, therefore, justify a higher productivity.[16] There are several problems with this analysis. First, it assumes that access rate reductions will be passed through to end users in the form of lower toll prices, which, in turn, increase the quantity demanded of interstate toll and carrier access. There is considerable evidence, however, that IXCs do not pass through access charges one for one thus reducing the stimulation of demand for carrier access resulting from access price reductions.[17] Second, with the own price elasticity of access estimated at -.3254,[18] economic theory indicates that price decreases in interstate access do not lead to revenue increases. Under this situation, the increase in quantity demanded as a result of the price change will be relatively less than the decrease in price leading to less total revenues. Third, in a post 1996 Act environment, the own price elasticity of the derived demand curve for access is less important because facilities-based competition and competition from unbundled network elements will affect the response of access minutes to a change in access price. Finally, AT&T suggests (at 71) that the demand stimulation from access charge reductions should lead to a higher productivity growth which would justify a higher productivity offset (X) in the price cap plan. On the contrary, a revenue-neutral access charge rebalancing will reduce, not increase,

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[16] AT&T Comments, p. 71.

[17] William E. Taylor and J. Douglas Zona, "An Analysis of the State of Competition in Long-Distance Telephone Markets" NERA, Inc., May 1995; See also Attachment to this paper which includes an analysis of the MCI white paper released January 27, 1997.

[18] "Productivity Offsets for Carrier Access Services of Local Exchange Carriers: 1984-1993 An Update of the FCC Short-Term Productivity Study," NERA, Inc., Prepared for United States Telephone Association, March 1995. Note that this estimate assumes full pass-through of carrier access rate reductions in toll prices.

measured productivity growth for the ILEC: a reduction in per-minute charges offset by an increase in flat-rate (line-based) charges would increase the revenue share of lines in the measure of output growth and reduce the revenue share of minutes. Since lines grow more slowly than minutes, the net effect on measured output growth is negative, and, all else equal, a given productivity growth target will be *more* difficult to attain under such rate rebalancing, not less.

In addition, the New York Public Service Commission ("NYPSC") analyzed those factors that could result in substantial reductions in interstate carrier access charges absent increases in other jurisdictions. They cite continued growth in interstate access minutes (if volume growth exceeds cost growth, per minute rates should decrease) and cost savings due to corporate downsizing and other efficiencies driven by competitive pressures. They calculate actual and potential growth in interstate switched access minutes and indicate that interstate carrier access usage has been subject to competitive displacement over the past (from CAPs and direct connections to customers) and has still managed to exhibit a significant and consistent growth rate. There are two problems with this analysis. First, it is incorrect to conclude that competitive pressure in the past—prior to the 1996 Act and the Interconnection Order—is a good estimate of future competitive conditions. In fact, we would expect competition in the future to be more robust thus affecting an ILEC's growth in access minutes. Second, the NYPSC presented a chart of interstate switched access minutes and concluded that it has grown over time despite CAP competition. The problem with this assertion is that, initially, CAPs main business was not switched access but rather special access and high-capacity services. A more proper approach, therefore, would have been to examine the growth in ILEC special access and high capacity service over time and use this figure as a basis to predict the change in switched access minutes due to increased competition. CAPs have indicated an intention and are in the process of expanding into switched access and should be greatly aided by the 1996 Act and the Interconnection Order.

There is also a conceptual problem with the notion that demand stimulation of interstate toll should be used to offset historical or regulatory costs incurred in the past, i.e.,

underdepreciation of assets, allocation of NTS costs to the interstate jurisdiction, etc. Reductions in access rates to their economic costs imply that the revenues obtained from demand stimulation offset the economic costs, including return on investment, of providing the increased quantity demanded of access. Historical and legacy costs, therefore, would still remain in place.

III. TELRIC/TSLRIC PRICING IS NOT NEEDED FOR EFFICIENT COMPETITION

Contrary to the claims of Professors Baumol, Ordover and Willig,[19] TELRIC/TSLRIC pricing is not necessary to establish efficient competition for interLATA toll services. Their analysis fails to consider: (i) structural and nondiscrimination safeguards contained in Section 272; (ii) price cap regulation by the Commission and many states that reduce LECs ability to cross-subsidize in any direction; (iii) rules that allocate costs between regulated and unregulated activities and between intrastate and interstate jurisdiction; and, most importantly, (iv) increasing access competition accelerated by UNEs.

A. Price Squeeze Safeguards

The ordinary price squeeze allegation asserts that the LEC will underprice its affiliate's long distance service relative to its carrier access service to drive long distance competitors from the market. While it is true that changes in access prices will affect the overall level of interexchange prices which, in turn, affect the size of the interexchange market and number of retail competitors, changes in access prices are competitively neutral in the interexchange market because *all* long distance suppliers pay the same tariffed price for access—including the 272 affiliate. Those firms that are most efficient in providing the non-access segment of the business can compete effectively. As the Commission has noted:

> The structural and nondiscrimination safeguards contained in section 272 ensure that competitors of the BOC's section 272 affiliate have access to essential inputs, namely, the provision of local exchange and exchange access services, on

[19] Baumol, Ordover and Willig.

terms that do not discriminate against the competitors and in favor of the BOC's affiliate[20]

Inherent in the arguments raised by Baumol, Ordover and Willig is the assertion that a BOC will not comply with accounting rules and other regulations that require it to deal with its 272 affiliate and with other IXC carriers on equal terms. However, experience to date in cellular, information services and intraLATA long distance markets indicates that such non-compliance is unlikely to be a serious problem.[21]

In addition, the prospect of increased profit from such a policy is non-existent. The ILEC sacrifices profits in the short run by pricing long distance below its incremental cost—including the opportunity cost from selling carrier access—and has no ability to recoup its lost profits in the long distance market by raising long distance prices in the future because competitive capacity is sunk and will not exit the market.

Some parties (AT&T, MCI) to this proceeding have advanced a different price squeeze theory. Suppose that access is priced above its incremental cost and consider a 272 affiliate that attempts to choose its rates to maximize *total* BOC profits: i.e., the sum of access profits and IXC profits. Because access is priced above its incremental cost, the BOC's access profits would be increased if the overall level of interexchange rates were reduced, all else equal. This increase stems from stimulated IXC demand volumes due to the lower IXC access costs passed through to customers through lower toll rates. Because access profits increase when IXC prices

[20] FCC 96-489, *First Report and Order*, CC Docket No. 96-149, issued December 24, 1996, ¶13.

[21] LECs have participated in cellular telephony since 1983. What is significant here is that the wireline licensees (the LECs) have not come to dominate the market, as would have happened if they had been able to subsidize these services from their local telephone services or had they been able to discriminate against non-wireline cellular rivals. In addition, many LECs have long been allowed to provide information services. From 1990 to 1995, the BOCs' participation in this market increased to 15% of the total Voice Messaging service with monthly charges dropping from $30 to $15. See Jerry Hausman and Timothy Tardiff, "Benefits and Cost of Vertical Integration of Basic and Enhanced Telecommunications Services," April 6, 1995. Finally, nearly all states permit intraLATA toll competition, and in none of them have the LECs been required to divest themselves of their toll business or even to create separate subsidiaries.

fall, it then follows that the 272 affiliate will charge lower prices than it would if it were interested only in maximizing IXC profits. As a logical matter, this theory is correct.

What the theory just outlined shows, however, is that when an IXC carrier is affiliated with an access provider charging a price above marginal cost, it will charge lower IXC prices than it would if it were an unaffiliated carrier. But lower prices benefit consumers, and more aggressive competition in the interexchange market is most likely to enhance economic efficiency.[22] Indeed, IXC prices lower than those charged by competitive non-integrated IXCs would increase economic welfare because they would offset the welfare loss caused by pricing access above incremental cost.

Consumers benefit when 272 affiliates aggressively push long distance prices down toward competitive levels. Moreover, large price reductions from current interstate toll prices would not be anticompetitive.[23] There is only a loss compared with the status quo if prices are forced substantially below cost, and the 272 affiliates would prefer such an outcome only under special conditions that have not been demonstrated to hold here.[24] (For example, overall IXC volume must be sufficiently responsive to price to offset the 272 affiliate's toll revenue losses with higher carrier access revenue).

For these reasons, we disagree with Professors Baumol, Ordover and Willig and Professor Kwoka who argue that maintaining access rates above competitive levels harms competition in the long distance market. Given the weaknesses associated with such

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[22] See attachment for an analysis of competition in long distance.

[23] At 18 cents average revenue per minute and 6 cents average access charge per minute, AT&T receives 12 cents of revenue net of access. Its incremental costs are roughly 2 cents per minute leaving room for about 10 cents per minute of price reductions above long run incremental cost. See AT&T *ex parte* letter in CC Docket No. 94-1, March 21, 1996; Lewis J. Perl and Jonathan Falk, "The Use of Econometric Analysis in Estimating Marginal Cost," Presented at Bellcore and Bell Canada Industry Forum, San Diego, California, April 6, 1989, Table 2; and R.W. Crandall and L. Waverman, *Talk is Cheap: The Promise of Regulatory Reform in North American Telecommunications*, Washington, D.C.: The Brookings Institution, 1995, p. 92.

[24] We note that the Commission recently reached the same conclusion. See *In re Applications of Pacific Telesis Group Transfer, and SBC Communications, Inc. Transferee, For the Consent to Transfer Control of Pacific Telesis Group and its Subsidiaries*, Report No. LB-96-32, Adopted January 31, 1997.

arguments, the FCC should not embark on a prescriptive approach to reforming access in order to counter a theoretical proposition that is unlikely to pose any serious threat to competition in long distance. In addition, we believe that increased competition in the exchange access market—from various sources and, as discussed below, especially from UNEs—renders this point moot. All parties in this Docket agree that carrier access charges should be reduced towards costs, and the effect of those price reductions—whether prescribed or market-based and whether reduced to TELRIC or to some competitive market level—would unambiguously ameliorate this problem, if one believed that this theoretical possibility was a problem.

B. Price Cap Protection

Concerns raised by Professor Kwoka[25] regarding price cap mechanisms should not influence the Commission to choose a prescriptive approach—with its likely market distortions—to access reform. Professor Kwoka fails to realize that it is not necessary to break every conceivable link between accounting costs and prices to reduce significantly the ability of a regulated firm to cross-subsidize and does not recognize that all but one of the RBOCs are under a pure price cap plan.

Rate-of-return regulation provides the regulated firm with an incentive to misallocate costs from competitive to non-competitive services.[26] Under such a scenario, predatory pricing for a competitive service may be combined with higher prices for non-competitive services to offset the losses from predation. Price cap regulation, on the other hand, provides the well-known benefit of reducing the ability and incentive of the regulated firm to cross-subsidize competitive services. In the words of the Commission:

> We find...that these incentives [to shift costs] under price caps are much less significant than under rate of return regulation, for the BOCs are no longer automatically entitled to increase rates to recoup cost increases. LEC price cap

[25] *Statement on LEC Price Cap Reform*, John E. Kwoka, Jr. MCI Comments.

[26] William J. Baumol, *Superfairness*, The MIT Press, Cambridge, Massachusetts, 1986, Chapter 6.

> regulation serves as an effective complement to cost accounting, reporting, auditing, and enforcement safeguards.[27]

The only remaining vestigial ties between accounting earnings and prices are contained in earnings sharing provisions and in the possibility that earnings history could affect future price cap parameters when the plan is reviewed. Much of Professor Kwoka's criticisms ignore the fact that all but one of the RBOCs are under a pure price cap plan without sharing. Whether a firm elects sharing, however, has little effect on the likelihood that subsidizing a competitive service would be profitable. Outside of the sharing range, there is no effect of earnings on prices, and the effect of accounting earnings on future prices through the review is speculative, occurs in the future, and contradicts the review criteria of most price cap plans. Productivity offsets in federal and state plans are almost always set with reference to: (i) the industry productivity experience rather than the productivity experience of a single firm; and (ii) the total company productivity growth, rather than the productivity growth for a subset of services. In these circumstances, the ability of a LEC to shift costs from one service to another would have a negligible effect on future values of the productivity offset and the future course of its telephone prices under price cap regulation. Moreover, even this link is disappearing. In its price cap review orders, the FCC took several steps to further reduce the link between costs and prices. The FCC: (i) established a long-term goal of eliminating sharing from the price cap plan;[28] (ii) proposed using an industry-wide measure of productivity growth based on all outputs of the firm;[29] and (iii) concluded that a moving average productivity calculation should be used to reduce the need to monitor productivity growth and change the productivity offset at future reviews.[30]

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[27] Computer III Remand Proceedings: BOC Safeguards and Tier 1 LEC Safeguards, 6 FCC Rcd 7571, 1991, ¶55 n. 95.

[28] Price Cap Performance Review for Local Exchange Carriers, First Report and Order, CC Docket No. 94-1, Released April 7, 1995, ¶s 193, 197.

[29] *Ibid.*, ¶s 145, 106.

[30] *Ibid.*, ¶ 145. The same result can be accomplished through the USTA proposal to have a set offset with no adjustment prior to deregulation.

C. Unbundled Network Elements Provide Additional Protection

AT&T's and MCI's economists fundamentally disregard the important role that UNEs will play in providing an effective Part 69 substitute which, in turn, further minimizes any alleged dangers of successful ILEC leveraging. Price squeeze arguments that do not take into account the rapidly increasing competition for access services—through UNEs and facilities-based suppliers—dramatically overstate the probability of success. To the extent that the access bottleneck will have been removed prior to the ILEC being permitted to supply long distance service in region, price squeeze arguments become moot.

Interconnection agreements which provide competitors with UNEs, interconnection, transport and termination, etc., provide competitors with concrete choices and alternatives to the Part 69 access regime. Successful price squeeze strategies require that there be a sole supplier in the access market. Although UNEs will be provided by the same firm, regulatory requirements establish an alternative to the current access regime at substantially *lower* prices. Therefore, it is entirely possible that this incentive effect will be eliminated by market and regulatory forces before it has any visible effect on market prices.

IV. A MARKET-BASED APPROACH IS SUPERIOR TO A PRESCRIPTIVE APPROACH

A. A Prescriptive Approach is a Repudiation of the Commission's Successful Price Cap Mechanism

A prescriptive cost-based approach to access reform is a repudiation of the Commission's current price cap mechanism which has been successful in achieving its goals of providing a better set of incentives for the LECs to pursue cost minimization. Price cap regulation has been effective and is a preferred basis for setting prices. IXC calls in this proceeding for reinitializing price caps to produce "competitive" access rates carry greater risks than any potential benefits and should be rejected. As mentioned above, "competitive" access levels based on unrealistic hypothetical proxy cost models are no substitute for allowing market