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FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY

Magalie Roman Salas  
Secretary  
Federal Communications Commission  
1919 M Street, NW  
Room 222  
Washington, DC 20554

Ex Parte Notice  
CC Docket No. 96-262

Dear Ms. Salas:

Enclosed are copies of letters and a paper prepared for the United States Telephone Association by Drs. Richard Schmalensee and William Taylor, which was attached to the letters delivered today to Commissioner Tristani, Commissioner Powell, Commissioner Ness and Chairman Kennard.

Two copies of this notice, the letters and the paper are being filed in the Office of the Secretary. Please include this notice in the public record of these proceedings.

Respectfully submitted,

Mary McDermott  
Vice President - Legal & Regulatory Affairs

cc (w/o attachment) Chairman Kennard  
Commissioner Tristani  
Commissioner Powell  
Commissioner Ness

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UNITED STATES  
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ASSOCIATION



January 20, 1998

The Honorable Gloria Tristani  
Commissioner  
Federal Communications Commission  
1919 M Street, NW  
Room 826  
Washington, DC 20554

Dear Commissioner Tristani:

*Gloria*

A top priority for the members of the United States Telephone Association (USTA) is the transition from regulation to competition in the telecommunications marketplace. It is imperative that a framework be created for adapting, streamlining, and eventually eliminating regulation as competition increases. USTA continues to urge the FCC to take action on putting such a framework in place for interstate access charge pricing.

I have attached a paper on the need for pricing flexibility for carrier access charges. The paper was commissioned by USTA and written by Dr. Richard Schmalensee and Dr. William Taylor. Dr. Schmalensee is the Gordon Y. Billard Professor of Economics at MIT, Deputy Dean of the MIT Sloan School of Management and Director of MIT's Center for Energy and Environmental Public Research. Dr. Taylor is a Senior Vice President of National Economic Research Associates, Inc. (NERA) and head of NERA's telecommunication economics practice. Both Dr. Schmalensee and Dr. Taylor have done substantial work in the areas of competition, pricing, competitive entry and regulatory reform and have appeared before Congress, the FCC and numerous state commissions concerning these and related issues.

I hope that you will find their analysis of the current state of the market -- and the economic and regulatory implications of the evolving marketplace -- helpful. Please contact me on (202) 326-7247 if you would like to discuss this issue or have questions about the paper.

Sincerely,

Roy Neel  
President & CEO

attachment



January 20, 1998

The Honorable Michael K. Powell  
Commissioner  
Federal Communications Commission  
1919 M Street, NW  
Room 844  
Washington, DC 20554

Dear Commissioner Powell: ~~Michael~~ -

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Sincerely,

A large, stylized handwritten signature in black ink, appearing to be the letter "R" followed by a vertical line and a horizontal stroke.

Roy Neel  
President & CEO

attachment



UNITED STATES  
TELEPHONE  
ASSOCIATION



January 20, 1998

The Honorable Susan Ness  
Commissioner  
Federal Communications Commission  
1919 M Street, NW  
Room 832  
Washington, DC 20554

Dear Commissioner Ness: *Susan*

A top priority for the members of the United States Telephone Association (USTA) is the transition from regulation to competition in the telecommunications marketplace. It is imperative that a framework be created for adapting, streamlining, and eventually eliminating regulation as competition increases. USTA continues to urge the FCC to take action on putting such a framework in place for interstate access charge pricing.

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Sincerely,

Roy Neel  
President & CEO

attachment



UNITED STATES  
TELEPHONE  
ASSOCIATION



January 20, 1998

The Honorable William E. Kennard  
Chairman  
Federal Communications Commission  
1919 M Street, NW  
Room 814  
Washington, DC 20554

Dear Chairman ~~Kennard~~: *Bill*

A top priority for the members of the United States Telephone Association (USTA) is the transition from regulation to competition in the telecommunications marketplace. It is imperative that a framework be created for adapting, streamlining, and eventually eliminating regulation as competition increases. USTA continues to urge the FCC to take action on putting such a framework in place for interstate access charge pricing.

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Sincerely,

Roy Neel  
President & CEO

attachment

**NATIONAL ECONOMIC  
RESEARCH ASSOCIATES**

ONE MAIN STREET, CAMBRIDGE, MASSACHUSETTS 02142  
TEL: 617.621.0444 FAX: 617.621.0336



**THE NEED FOR CARRIER ACCESS PRICING FLEXIBILITY  
IN LIGHT OF RECENT MARKETPLACE DEVELOPMENTS**

**A Primer**

**by**

**Richard Schmalensee and William Taylor**

## QUALIFICATIONS

Richard Schmalensee is the Gordon Y. Billard Professor of Economics at the Massachusetts Institute of Technology (MIT), Deputy Dean of the MIT Sloan School of Management, and Director of MIT's Center for Energy and Environmental Policy Research. He also is a Special Consultant to National Economic Research Associates, Inc., a Director of the Long Island Lighting Company, a former Member of the EPA's Environmental Economics Advisory Committee, and a Member of the EPA's Clean Air Act Compliance Analysis Council. He served as a Member of President Bush's Council of Economic Advisors with primary responsibility for domestic and regulatory policy, including environmental and telecommunications policy and for U.S. assistance to Central and Eastern Europe. He served for several years as a consultant to the Bureau of Economics of the Federal Trade Commission.

Dr. Schmalensee has done extensive research on aspects of industrial organization and antitrust policy, particularly nonprice competition and conditions of entry. He has also studied the telecommunications industry, the electric power sector and general issues of regulation and regulatory reform. He has testified in both federal and state courts, before several Congressional committees, and before the Federal Trade Commission, and he has served as a consultant on regulatory and competitive issues to numerous organizations in the United States and abroad.

He received his S.B. and Ph.D. degrees in economics from MIT and taught for some years at the University of California, San Diego. At MIT, he teaches graduate courses in industrial organization, its applications to management decisions, government regulation and government/business relations. He has published over 60 articles in professional journals, including *The American Economic Review*, *The RAND Journal of Economics*, *The Harvard Law Review*, *The Journal of Econometrics*, *Public Utilities Fortnightly*, *Econometrica*, *The Journal of Law and Economics*, *The Journal of Industrial Economics*, *The Economic Journal*, *The Antitrust Law Journal*, *The International Journal of Industrial Organization*, *The Quarterly Journal of Economics*, and *The Journal of Economic Perspectives*.

He is the author of *The Economics of Advertising* and *The Control of Natural Monopolies* and co-author of *Markets for Power*. He is also co-editor of the *Handbook of Industrial Organization* and founding editor of the MIT Press Regulation of Economic Activity monograph series. He has served on the editorial boards of *The American Economic Review*, *Zeitschrift für Nationalökonomie*, *The International Journal of Industrial Organization*, *The Journal of Economic Perspectives*, *Recherches Économiques de Louvain*, and *The Journal of Industrial Economics*. He has served on the Executive Committee of the American Economic Association and is a Fellow of the Econometric Society and the American Academy of Arts and Sciences.

William Taylor is a Senior Vice President of National Economic Research Associates, Inc. (NERA), head of its telecommunications economics practice and head of its Cambridge office. He received a B.A. degree in economics, *magna cum laude*, from Harvard College in 1968, a master's degree in statistics from the University of California at Berkeley in 1970, and a Ph.D. in Economics from Berkeley in 1974, specializing in industrial organization and econometrics. He has taught and published research in the areas of microeconomics, theoretical and applied econometrics, and telecommunications policy at academic institutions (including the economics departments of Cornell University, the Catholic University of Louvain in Belgium, and the Massachusetts Institute of Technology) and at research organizations in the telecommunications industry (including Bell Laboratories and Bell Communications Research, Inc.). He has participated in telecommunications regulatory proceedings before state public service commissions, the Federal Communications Commission and the Canadian Radio-Television and Telecommunications Commission concerning competition, incentive regulation, price cap regulation, productivity, access charges, telecommunications mergers, pricing for economic efficiency, and cost allocation methods for joint supply of video, voice and data services on broadband networks.

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referee for these journals (and others) and the National Science Foundation and has served as an Associate Editor of the *Journal of Econometrics*.

## QUALIFICATIONS

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## EXECUTIVE SUMMARY

This paper is a primer on the current state of carrier access markets and on the importance of granting ILEC pricing flexibility. It explains why there is an urgent need for increased flexibility. The consequences of inactivity are severe; significant economic distortions are likely. In some cases—where market forces rather than regulation already determine prices—the delay in granting flexibility has likely already resulted in welfare losses. Relief should have been granted long ago in these cases.

The current and evolving state of market forces for many carrier access services combined with the implementation of the Telecommunications Act of 1996 (the “96 Act”) establish a competitive and emerging competitive environment in which ILEC pricing flexibility is necessary to generate efficient responses to competition. Competition does not come to all service and geographic markets in the same way or at the same time. Consequently, the Commission must first rely on market forces to determine efficient outcomes and second, establish a clear framework or set of triggers that will result in flexibility as competition comes to specific markets. Since demand is not evenly distributed across customers, there is an urgent need for the Commission to act quickly. The loss of a few large customers can have severe impact on the ILECs. While competition inevitably leads to customers switching suppliers, it would be economically inefficient if customers switched to competitors, not because they were more efficient, but because regulation encouraged inefficient entry and/or prevented the incumbent from reducing prices to respond to competition. Among our major conclusions:

- There are several simple pricing flexibility principles that the Commission should follow: First, market forces are vastly superior than reliance on regulation to determine efficient levels of output, investment and price, as a result, the Commission should primarily rely on them. Second, it is essential to reduce unnecessary asymmetric obligations when the market is *first* fully opened to competitors. Third, the Commission should pursue a policy that rewards efficiency, not one that protects particular competitors. Fourth, rates should reflect specific costs and conditions in specific markets.
- Past history in telecommunications and other markets as well as economic theory suggest that welfare losses to society as a result of delaying flexibility and deregulation

can be significant.

- The Commission should immediately permit ILECs to deaverage interstate access rates so as to more closely align rates with the way they incur costs and to prevent arbitrage resulting from UNE deaveraged rates.
- Volume and term discounts and customer-specific contracts are useful strategies in competitive markets that benefit customers and prevent inefficient investment in the network. Current market conditions justify this type of pricing flexibility for many ILEC carrier access services because competitors, large and well-financed, are able to offer such pricing plans.
- There are ILEC carrier access services such as special access and dedicated transport that are already sufficiently constrained by market forces. Continued regulation of these services serves no beneficial purpose. Forbearing from regulating such services is appropriate and consistent with economic principles.
- The main effect of the existence of interconnection agreements with UNEs at cost-based rates is to make many ILEC customers potential CLEC customers, constrained only by the ability to convince end users to switch to the CLEC. Many ILEC customers, therefore, are immediately vulnerable to competitors and as such the existence of interconnection agreements should give the Commission a sense of urgency to act by permitting market forces to substitute for regulatory constraints.
- For those remaining carrier access services where competitive forces are not, at present, sufficiently developed to constrain prices, our recommendation is to implement objective criteria which identify the stages of competition in individual markets at which regulation should be reduced with the ultimate objective of eliminating regulation.

## I. INTRODUCTION

The passage of the Telecommunications Act of 1996 and the adoption of the Commission's Interconnection Order<sup>1</sup> have significantly and permanently increased the ability of competitive local exchange carriers (CLECs)<sup>2</sup> to compete for local exchange and carrier access customers.<sup>3</sup> Prior to these events, economic and technological forces had already begun to reduce economic barriers to entry: competitive access providers (CAPs)<sup>4</sup> increasingly supplied special<sup>5</sup> access services in competition with the incumbent local exchange carrier's (ILEC's) switched and special (exchange) access services. These trends—apart from the 96 Act or any Commission action—have continued and advanced to such an extent that competitors' incentives to enter as facilities providers are growing and expanding at an increasingly fast pace. More recently, the Commission's Orders implementing the 96 Act have permitted competitors to share in the economies of scale, scope and density that permeate local exchange markets. Competitors need no longer duplicate the ILEC's network but rather can use all or part of that network to compete for retail local exchange and carrier access customers, purchasing unbundled network elements (UNEs) and interconnection from the ILEC. This makes most ILEC customers potential competitive targets, with competitors constrained only

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<sup>1</sup> *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, Report and Order*, 11 FCC Rcd 15499 (1996) *vacated in part and aff'd in part sub nom. Iowa Utilities Board; Order on Reconsideration*, 11 FCC Rcd 13042 (1996); *Third Order on Reconsideration and Further Notice of Proposed Rulemaking*, CC Docket Nos. 96-98, 95-185, FCC 97-295 (rel. Aug. 18, 1997); *Iowa Utilities Board v. FCC*, Nos. 96-3321, et al. (8<sup>th</sup> Cir. July 18, 1997).

<sup>2</sup> CLECs are new local exchange competitors that have entered an area traditionally served only by a single incumbent exchange carrier (ILEC). Thus, AT&T is a CLEC where it offers local exchange service, as is an established local exchange company that has entered a new serving area.

<sup>3</sup> Local exchange customers are residential and business end users who buy access to the public switched network, local usage and vertical services (e.g., call waiting). Carrier access customers are long distance suppliers who purchase carrier access to originate and terminate traffic in the local exchange. Carrier access is the process by which Interexchange Carriers (IXCs) like AT&T or MCI interconnect to the local exchange networks.

<sup>4</sup> Examples of CAPs are WorldCom-MFS and ACSI.

<sup>5</sup> Special access is a dedicated form of carrier access, essentially a private line between the interexchange carrier ("IXC") and a high-volume end user.

by their ability to convince customers to switch.<sup>6</sup> Current marketplace conditions in carrier access markets are such that the Commission can safely rely on market forces to constrain many prices, rather than being forced to employ archaic regulatory rules that hinder the development of efficient competition.

What strategies make sense in markets subject to different amounts of competitive pressures? As a general economic principle, where market forces are sufficiently robust, they should be permitted to determine results. Where regulation is still required to protect some customers for some services, that regulation must not be permitted to determine results permanently. As local markets become increasingly open to competition, there is an urgent need for the Commission to act quickly to ensure that regulation is competitively neutral. Demand is not evenly distributed across customers, and the loss of a few large customers can have a severe financial impact on the market.<sup>7</sup> While permitting competition inevitably leads to customers switching suppliers, it would be seriously inefficient if customers switched to new suppliers not because they were more efficient but because regulations prevented the incumbent from competing. Any delay in granting pricing flexibility to the ILEC in markets where competitive forces are already strong will inevitably result in this narrow, and most mobile, segment of the market moving to competitors, with the incumbent unable to respond. The availability of interconnection agreements (with UNEs at cost-based prices) combined with the presence of facilities-based competitors immediately establishes the need for extensive ILEC pricing flexibility in order to ensure competitively neutral regulation and permit competition to produce hoped-for efficiencies.

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<sup>6</sup> The recent decision of the Eighth Circuit Court of Appeals (*Iowa Utilities Board v. FCC*, Nos. 96-3321, et. al. 8<sup>th</sup> Circuit July 18, 1997) determines that ILECs are not required to recombine unbundled network elements (e.g., a loop and a port) when they are purchased by a CLEC. As a practical matter, however, UNEs remain an effective substitute for ILEC switched access for many customers because the CLEC (i) can negotiate with the ILEC to rebundle elements or (ii) can recombine UNEs itself, e.g., using physical or virtual collocation to recombine an unbundled loop and a port.

<sup>7</sup> Entrants have the ability to target only a few geographic areas and yet obtain significant revenues. In the BellSouth region, for example, almost one third of all BellSouth's South Carolina business revenues are generated by business customers served by only 5 of the 115 wire centers currently operating in South Carolina. Affidavit of Gary M. Wright, *In the Matter of Application of BellSouth Corporation to Provide In-Region, InterLATA Long Distance Services under Section 271 of the Telecommunications Act of 1996*.

In combination with current market conditions, the availability of UNEs requires that carrier access services such as special access and dedicated transport<sup>8</sup> be immediately removed from regulatory constraints. These services satisfy the requirements for regulatory forbearance<sup>9</sup> because competitive forces in these markets are sufficiently developed to constrain market power. Similar circumstances now apply in some switched access markets where, for certain customers in certain geographic areas, the ILEC's market power is constrained by actual and potential competition from facilities-based competitors.<sup>10</sup> Permitting market forces to determine prices, output and levels of investments in these markets is vastly superior to economic regulation. For competition to be efficient, regulatory constraints must, therefore, immediately adapt as well.

As experience has shown, carrier access services are not homogenous. Competition in markets for access services will develop at different rates. Because the carrier access market is not a monolith, if all ILECs had to wait until competition reached all geographic and customers segments, most would not get relief until it was far too late. Accordingly, it is imperative that the Commission implement workable procedures to identify markets for which residual regulation is necessary and to establish a clear and achievable path for the ILECs' services to move through degrees of pricing flexibility and ultimately to regulatory forbearance in a manner that is responsive to increases in potential and actual competition. In these cases, as in general, the Commission's ultimate goal should be that of the 96 Act: to substitute market forces for regulation.

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<sup>8</sup> Dedicated transport is a transmission service provided on circuits dedicated to the use of a single IXC or other person.

<sup>9</sup> According to Section 10(a) of the Telecommunications Act of 1996, the Commission can forbear from regulation of a service if: enforcement of the rule or regulation is not necessary to ensure that rates are just and reasonable or not unjustly or unreasonably discriminatory; enforcement of the rule or regulation is not necessary for the protection of consumers and forbearance is consistent with the public interest.

<sup>10</sup> Facilities-based competitors in the local exchange and carrier access markets include CAPs and other CLECs that build their own networks, (augmenting them to a varying degree with facilities (UNEs) purchased from the ILEC).

## II. PRICING FLEXIBILITY

### A. Principles

The carrier access market is characterized by an absence of legal barriers to entry, combined with low economic entry barriers. In addition, effective competition already exists for many carrier access services in many geographic markets. As will be described in greater detail below, these facts establish the necessity for more flexible regulatory constraints on the ILECs' carrier access services so that regulation will ultimately not stand in the way of efficient competition. In this section, we describe and recommend the basic pricing flexibility principles that the Commission should follow. Based on economic theory and regulatory experience in other markets, the following simple pricing flexibility principles emerge:

First, competitive market forces are vastly superior to regulation in the determination of efficient levels of output, investment and price. Thus, where it can safely rely on market forces, the Commission should do so.

Second, delay is costly. To avoid incentives for inefficient investment, unnecessary asymmetric regulatory obligations must be eliminated when markets are *first* fully opened to competitors.

Third, consumers benefit from policies that foster overall economic efficiency, not policies that protect particular competitors or technologies.

Fourth, prices should approximate their market levels under competitive conditions.

The importance of ILEC pricing flexibility is best understood by examining the role prices play in a market economy. Market economies work well because the selfish uncoordinated interaction of suppliers and consumers can result in efficient production and distribution of society's resources. The fulcrum that ensures that proper signals are sent to direct production and consumption is the price system. Efficient and undistorted prices allocate

scarce resources among competing ends resulting in full technical and allocative efficiency.<sup>11</sup> Thus, undue constraints on an ILEC's pricing lead to losses in economic efficiency because incorrect market signals are provided to participants.<sup>12</sup>

Moreover, incorrect market signals can lead to inefficient investments in the telecommunications network: e.g., when a customer decides to purchase from a competitor whose incremental cost is higher than the ILEC's but who, nevertheless, can charge a lower price because the ILEC is prevented from responding by tariff constraints. Such investment results in inefficient duplication of the telecommunications network which raises the cost of telecommunications services to all customers (because customers are not receiving the lowest possible price) and creates a burden (of recovering shared fixed and common costs over a smaller base of customers) for those customers remaining on the ILEC's network. Whenever they can reasonably be expected to be strong, market forces should be primarily relied on to determine market outcomes. Many existing services can and should be controlled through market forces, even if competition is somewhat imperfect, rather than through inevitably imperfect regulation. As stated by Alfred Kahn:

Regulation is ill-equipped to treat the more important aspects of performance—efficiency, service innovation, risk taking, and probing the elasticity of demand...All competition is imperfect; the preferred remedy is to try to diminish the imperfections<sup>13</sup>

The social costs of regulatory constraints that artificially increase costs and fail to provide meaningful consumer benefits and/or protections can be staggering. This is especially the case in a rapidly changing and dynamic telecommunications environment. An egregious

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<sup>11</sup> Technical efficiency is maximized when output is supplied at the lowest possible cost. Allocative efficiency is reached when customers' consumption decisions are based on the incremental costs of supplying goods and services.

<sup>12</sup> Because the ILECs may have residual market power in some carrier access markets, price regulation is appropriate—although we believe conditions exist for effective competition. We use the word “undue” to indicate that there are many constraints present on ILEC services that do more harm than good.

<sup>13</sup> Alfred E. Kahn, *The Economics of Regulation Principles and Institutions*, Volume ii, chapter 7, The MIT Press, 1995.

example of the harms that can result from delay and not permitting market forces to work is the licensing of cellular telecommunications. The 10 to 15 year regulatory delay in licensing systems is estimated to have cost society more than \$86 billion or about 2 percent of GNP in 1983 when cellular service began.<sup>14</sup>

Moreover, unnecessarily delaying the offering of new and innovative services demanded by customers, by requiring public interest tests to obtain relief from regulatory constraints for new service offerings can impose high costs on society. Voice messaging services provide another example. Additional consumer welfare from the availability of LEC voice messaging services has been estimated at between \$800 million and \$1.4 billion per year, so that [g]overnment actions which either speed up or delay the introduction of these new services can have important welfare effects on the economic welfare of its citizens.<sup>15</sup>

Once a determination has been made that competition can work “as effectively” as regulation in some market, overall economic efficiency requires that—simultaneously—the market be opened to competitive entry and the regulated firm be relieved of unnecessary, asymmetric regulatory constraints. The most troublesome regulatory constraints are those that prevent ILECs from competing effectively; these may have the effect of preventing the least-cost supplier from providing the service. Removing such constraints will ensure that entrants and incumbents will make efficient entry and expansion decisions some of which entail large investments. In order for consumers and competitors to be given accurate and efficient price signals, competition involving all firms, including the incumbent, must occur on as symmetric a basis as possible. Otherwise, market signals will lead to a wasteful use of society’s scarce resources. By adopting this approach, entrants are given accurate market signals which lead to entry in those instances where their economic costs of providing the service are less than or equal to the incumbent’s economic cost. Therefore, a principal goal of regulatory policy when

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<sup>14</sup> J.H. Rohlfs, C.L. Jackson and T.E. Kelley, “Estimate of the Loss to the United States Caused by the FCC’s Delay in Licensing Cellular Telecommunications,” NERA report, November 4, 1991.

<sup>15</sup> Hausman, J. and T. Tardiff, “Valuation of New Services in Telecommunications,” in A. Dumont and J. Dryden, The Economics of the Information Society, Luxembourg: Office for Official Publications of the European Communities, 1997, at 80.

competition begins in a market previously served by a sole provider should be to reduce, to the greatest extent possible, unnecessary asymmetric obligations on the market participants. Pursuing such a policy ensures that a provider's efficiencies and relative abilities to supply customer demands—not regulatory distortions—determine its success in the market.

Estimates of the potential welfare gains to society from deregulating telecommunications—and actual experience in other industries—highlight what is at stake before the Commission. Maintaining unneeded regulatory constraints on markets long after they are no longer required has imposed significant economic costs on U.S. consumers. In a 1996 study, Crandall and Waverman estimate that the net gains from telecommunications deregulation that leads to more efficient pricing is almost \$30 billion.<sup>16</sup> That same year, Crandall and Furchtgott-Roth analyzed the cable TV industry during, *inter alia*, the period when services were deregulated.<sup>17</sup> They found that households were collectively \$6.5 billion a year better off with cable's services in 1992 (after deregulation) than with those of 1983-84 (before deregulation). Moreover, viewers had many more and better-quality viewing choices during the period of deregulation. Earlier, Clifford Winston analyzed the welfare effects of deregulation in airlines, railroads and trucking and found comparable net gains in welfare:<sup>18</sup> in total, at least \$36-\$46 billion (1990 dollars) annually from deregulation with the bulk of the benefits going to consumers.<sup>19</sup>

A policy that should **not** be followed implicitly or explicitly—though it has been sometimes in the past—is to attempt to protect and assist competitors rather than the competitive process. One of us recognized this problem nearly a decade and a half ago:

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<sup>16</sup> Robert W. Crandall and Leonard Waverman, *Talk is Cheap: The Promise of Regulatory Reform in North American Telecommunications*. Brookings Institution (1996).

<sup>17</sup> Robert W. Crandall and Harold Furchtgott-Roth, *Cable TV: Regulation or Competition?*, The Brookings Institution (1996).

<sup>18</sup> Clifford Winston, "Economic Deregulation: Days of Reckoning for Microeconomists," *Journal of Economic Literature*, Vol. XXXI (September 1993), pp. 1263-1289.

<sup>19</sup> Welfare gains from deregulation (in 1990 dollars) were estimated at \$13.7-\$19.7 billion, \$10.4-\$12.9 billion and \$10.6 billion for the airline, railroad and trucking industries, respectively.

As a permanent, long-run policy, the Commission's choice should be between regulation of a single supplier of telecommunications services (if natural monopoly elements are important) and unregulated competition (if they are not).<sup>20</sup>

The Commission should not implement policies that have as their goal the survival of competitors at the cost of aggregate welfare losses to society. There are many examples of such policies: a particularly egregious example is to withhold pricing flexibility from the incumbent carrier until after competitors have (artificially) succeeded in the marketplace. As discussed in more detail below, such a policy creates economic distortions in the marketplace and leads to inefficiencies and lower consumer welfare. As Almarin Phillips observed in the early days of telecommunications competition,

(t)hrough regulation of one kind or another—legislation, injunctions, consent decrees, or regulatory edicts—the pricing and services at AT&T, the BOCs, and other non-Bell participants in the switched network can be arranged so that all are viable. That is, regulations can be formulated to preserve and protect an inefficient structure with many firms. Competition, nonetheless, is just the opposite of this. The idea of competition is to have a market structure that, without regulation, induces efficient pricing.<sup>21</sup>

Commission policies should be competitor-neutral so that a provider's efficiencies and relative abilities to supply customer demands determine its success in the market. As a former Head of the Commission's Office of Plans and Policy put it,

An important potential source of governmental failure rests in the fallacious notion that deregulation can be permitted by regulators only when markets become, somehow measured, competitive. That notion is fallacious because it characterizes competition as a static goal rather than a dynamic process. Competition is a means, not an end. Failure to draw and act on this important distinction means that policymakers run the risk of creating a wholly artificial industry structure based on inefficient pricing and entry.<sup>22</sup>

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<sup>20</sup> "Statement of Richard Schmalensee," Attachment 4 to *Comments of AT&T* in CC Docket No. 83-1147, April 2, 1984 at 3-4.

<sup>21</sup> Almarin Phillips, "The Impossibility of Competition in Telecommunications: Public Policy Gone Awry," in *Regulatory Reform and Public Utilities*, Michael Crew (ed.), Lexington, MA: Lexington Books, 1982 at 23.

<sup>22</sup> John Haring, "The FCC, the OCCs and the Exploitation of Affection," OPP Working Paper No. 17, June 1985  
(continued...)

At the heart of the arguments in favor of protecting competitors is the notion that competitors in these markets are infants that need protection until they grow up and are weaned from the Commission's protection.<sup>23</sup> While the infant industry argument sometimes finds economic supporters in the area of international trade, the circumstances that may lead to adoption of such a strategy—infancy, inexperience in the field and inability to acquire key resources—are completely absent in the carrier access and local exchange market.<sup>24</sup> Among the ILECs' competitors are large, sophisticated corporations with national and global networks. These entrants—including AT&T, WorldCom-MFS, MCI and Sprint—are eminently experienced in telecommunications markets, have ambitious plans to enter the local exchange market and carrier access market and are more than capable of competing effectively.<sup>25</sup>

For example, according to Morgan Stanley investment analysts, AT&T is expected to spend about \$1.5 to \$2.0 billion per year over the next seven years on local exchange infrastructure.<sup>26</sup> AT&T clearly has enormous resources to compete effectively and has the technological expertise to develop new bypass technologies such as wireless loops for local exchange and exchange access service. In February, AT&T “announced plans...to link its wireless phone network directly to millions of home phone lines, offering consumers a new way to make local calls and speed access to the Internet.”<sup>27</sup> Although AT&T reported that the

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at 3-4.

<sup>23</sup> Something which is likely to be opposed by the competitors “even after the children are grown up and off to college.” Infant industry protection provides perverse incentives to compete in the hearing room rather than devoting resources to lowering costs and expanding demand because the marginal gains from regulatory rent-seeking are substantial. Once preferential treatment is given, recipients have strong vested interests to maintain it, as the Commission's experience with the eventual termination of regulating AT&T as a dominant carrier.

<sup>24</sup> The infant industry argument is the belief that emerging industries need to be protected from more efficient, established, foreign competitors until they can build market share and lower costs through economies of scale and learning-by-doing. It is used as justification for implementing or maintaining tariffs.

<sup>25</sup> Since this sentence was first written, AT&T and WorldCom have announced their intentions to acquire Teleport and MCI respectively. Both mergers increase their constituents' ability to supply end-to-end bundled services to (primarily large business) customers, and unlike the ILECs with which they compete, the prices and services of the resulting firms are not subject to pervasive regulation.

<sup>26</sup> Stephanie Comfort, “AT&T: Happy New Year,” Morgan Stanley, January 31, 1997, p. 9.

<sup>27</sup> “AT&T to Test Wireless Homes” The Associated Press, *The New York Times*, February 26, 1997, p. D21.

system trial, slated for the fourth quarter 1997 in Chicago, will be delayed until 1998 because the hardware and antennas which support the network will not be ready, the company has no plans to abandon its wireless loop technology undertaking. While in November 1997, AT&T announced that it had “all but stopped marketing efforts to win new residential customers in the six states where it has launched competitive local services,” its commitment to competing in the local exchange market—particularly for business customers—was clearly revealed in its \$11.3 billion acquisition of Teleport Communications Group announced on January 8, 1998<sup>28</sup>. In addition, MCI has made major commitments to enter the local market and bypass ILEC access, deploying fiber-optic rings in major markets around the country, beginning with a \$2 billion plan to put fiber-optic systems through abandoned Western Union conduit in the 20 largest US cities.<sup>29</sup> Its acquisition by WorldCom will produce a formidable competitor in local exchange and exchange access markets and in the market for supplying bundled local exchange and long distance services to retail customers.

Competitors frequently point to the power and advantages of incumbency and argue that regulators have to offset such advantages in order for competitors to be able to compete and survive.<sup>30</sup> Usually these arguments boil down to preventing flexibility or diversification because incumbents are in a position to exploit economies of scale and scope that are lacking and are not available, to the same degree, by competitors. This argument is disturbing for a number of reasons. Having once decided that competition is national policy in *all* telecommunications markets, it would be disastrous to micromanage the process and penalize efficiency. Competitors would have the Commission evaluate and measure respective economies of scale and scope to use as a basis in regulatory decisions. Such a policy would be

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<sup>28</sup> “AT&T Cuts Back Marketing of Residential Local Service,” *Telecommunications Reports*, November 17, 1997, at 31. Seth Schiesel, “AT&T Agrees to Acquire Local Telephone Carrier,” *New York Times*, at <http://www.nytimes.com>, January 9, 1998.

<sup>29</sup> Edmund L. Andrews, “MCI Plans to Enter Local Markets,” *The New York Times*, January 5, 1994, p. D1. See also “MCI Seeks to Be ‘Local’ in 5 States,” *The New York Times*, October 4, 1994.

<sup>30</sup> See, e.g., Robert E. Hall, on behalf of MCI, In the Matter of Application of SBC Communications Inc., et. al. For Provision of In-Region, interLATA Services in Oklahoma, before the Federal Communications Commission, CC Docket No. 97-121, p. 55.

disastrous because it would reduce the consumer benefits that were the primary focus of the 96 Act—improved technical and allocative efficiencies. Artificial advantages should not be given to any market participant in order to offset putative advantages in economies of scale and scope.

Moreover, such arguments fail to take into account the *raison d'être* of current market forces in telecommunications. Diversification into closely related markets (e.g., IXCs entering regional toll or carrier access) is being propelled by technological and economic factors causing the same competitors to take advantage of exactly the same kinds and sources of economies of scope. These new competitors, unencumbered by asymmetric regulations clearly intend to extend their product offerings and reap economies of scale and scope. More dangerous from a public policy perspective, competitors intend to enter and serve the lucrative customers leaving aside higher-cost ones. According to former CEO Robert Allen:

It's logical that bees follow honey and banks are robbed because that's where the money is. And our focus will be on concentrated markets in major cities with concentrations of business customers.<sup>31</sup>

Clearly, it is not sound public policy to protect such competitors; rather, consumers are better served if each carrier's relative efficiencies are allowed to determine its success in the market. Experience in other industries indicates the dangers and costs to society from asymmetric regulation and competitive entry such as we experience today in the carrier access markets. In a recent paper, Dr. Robert G. Harris measured the cost to the freight transportation industry of maintaining excess capacity in the form of routes which did not cover their own costs to be in the range of \$3.4 billion and \$15.4 billion in 1995 dollars.<sup>32</sup> Dr. Harris estimated that there was a \$1.6 billion per year net gain in railroad profitability (in 1977 dollars) and that consumers gained an estimated \$3.62 billion per year (in 1977 dollars) as a result of recent

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<sup>31</sup> Roy Neel, "Static on the Line." *Chicago Tribune*, December 11, 1996.

<sup>32</sup>Robert G. Harris, "Toward Regulatory Symmetry in Local Exchange Services: Lessons From Financial Services and Freight Transportation," Presented to the Industrial Organization Society Allied Social Science Associations, San Francisco, January 5, 1996.