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July 17, 1998

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Magalie Roman-Salas
Secretary
Federal Communications Commission
1919 M Street, N.W., Rm. 222
Washington, D.C. 20554

Re: CC Docket Nos. 94-1, 96-45 and 96-262

Dear Ms. Roman-Salas:

On July 16, 1998, the undersigned and Linda Kent, Associate General Counsel, United States Telephone Association (USTA), met with Kathryn C. Brown, Chief of the Common Carrier Bureau, Craig J. Brown, Aaron R. Goldschmidt and Blaise A. Scinto, also from the Common Carrier Bureau, to discuss matters concerning the above-referenced proceedings.

In accordance with Section 1.1206(b)(2) of the Commission's rules, two copies of the attached summary of the presentation are being submitted to your office for filing in each of the referenced proceedings. Also attached are copies of a document entitled, "The Need for Carrier Access Pricing Flexibility in Light of Recent Marketplace Developments," by Richard Schmalensee and William Taylor, that was distributed at the meeting. In accordance with Section 1.1206(b)(1) of the Commission's rules, two copies of the Schmalensee and Taylor document are being submitted for inclusion in each of the records for CC Docket Nos. 94-1 and 96-262. Please contact me if you have any questions.

Respectfully submitted,

Lawrence E. Sarjeant

Lawrence E. Sarjeant
Vice President Regulatory Affairs & General Counsel

cc: K. Brown
C. Brown
A. Goldschmidt
B. Scinto

attachments

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Summary of Ex Parte Presentation
CC Docket Nos. 94-1, 96-45 and 96-262

On July 16, 1998, Linda Kent, Associate General Counsel, United States Telephone Association (USTA) and Lawrence E. Sarjeant, Vice President Regulatory Affairs and General Counsel, USTA, met with Kathryn C. Brown, Chief of the Common Carrier Bureau, Craig J. Brown, Aaron R. Goldschmidt and Blaise A. Scinto, also from the Common Carrier Bureau. The issues discussed are summarized as follows:

1. As to the implementation of universal service programs, implementation of the fund for high cost support should be the Commission's first priority. Specific to the implementation of the fund for high cost assistance for non-rural companies, it is important that the Commission act expeditiously to implement the program and meet its self-imposed deadline of January 1, 1999. To the extent that matters are referred to the Federal-State Joint Board, every effort should be made to promote prompt action and expeditious return of the matter to the Commission for final action.

2. With respect to interstate access charges for price cap ILECs, the Commission should stay the course with respect to the market-based approach to regulating access charges and should move quickly to provide price cap ILECs with access charge pricing flexibility. The Commission should not retrench and move back to a prescriptive approach to access charge regulation. The Commission should not act precipitously in attempting to lower access charges.

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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 fur Nationalokonomie*, *The International Journal of Industrial Organization*, *The Journal of Economic Perspectives*, *Recherches Economiques 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.

His articles have appeared in numerous telecommunications industry publications as well as *Econometrica*, *the American Economic Review*, *the International Economic Review*, *the Journal of Econometrics*, *Econometric Reviews*, *the Antitrust Law Journal*, *The Review of Industrial Organization*, and *The Encyclopedia of Statistical Sciences*. He has served as a referee for these journals (and others) and the National Science Foundation and has served as an Associate Editor of the *Journal of Econometrics*.

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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.

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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[1] have significantly and permanently increased the ability of competitive local exchange carriers (CLECs)[2] to compete for local exchange and carrier access customers.[3] Prior to these events, economic and technological forces had already begun to reduce economic barriers to entry: competitive access providers (CAPs)[4] increasingly supplied special[5] 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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[1] *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. (8th Cir. July 18, 1997)

[2] 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.

[3] 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.

[4] Examples of CAPs are WorldCom-MFS and ACSI

[5] 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.[6] Current marketplace conditions in carrier access markets are such that the Commission can safely rely on market forces to constrain many prices, rather then 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.[7] 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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[6] The recent decision of the Eighth Circuit Court of Appeals (Iowa Utilities Board v. FCC, Nos. 96-3321, et. al. 8th 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

[7] 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[8] be immediately removed from regulatory constraints. These services satisfy the requirements for regulatory forbearance[9] 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.[10] 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 <u>all</u> 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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[8] Dedicated transport is a transmission service provided on circuits dedicated to the use of a single IXC or other person.

[9] 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.

[10] 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.[11] Thus, undue constraints on an ILEC's pricing lead to losses in economic efficiency because incorrect market signals are provided to participants.[12]

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[13]

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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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

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.

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.[14]

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.[15]

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

[14] 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.

[15] 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.[16] That same year, Crandall and Furchtgott-Roth analyzed the cable TV industry during, *inter alia*, the period when services were deregulated.[17] 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:[18] in total, at least $36-$46 billion (1990 dollars) annually from deregulation with the bulk of the benefits going to consumers.[19]

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

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

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

[19] 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).[20]

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.[21]

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.[22]

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

[21] 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.

[22] 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.[23] 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.[24] 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.[25]

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.[26] 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."[27] Although AT&T reported that the

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(...continued)

at 3-4.

[23] 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.

[24] 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.

[25] 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.

[26] Stephanie Comfort, "AT&T: Happy New Year," Morgan Stanley, January 31, 1997, p. 9.

[27] "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[28]. 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.[29] 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.[30] 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

[28] "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

[29] 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.

[30] 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.[31]

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.[32] 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

[31] Roy Neel, "Static on the Line," *Chicago Tribune*, December 11, 1996.

[32] 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

Congressional deregulatory actions.[33]

Dr. Harris also measured the economic harm incurred from regulation in the banking industry. While banks were subject to interest rate restrictions, universal service restrictions under the Community Reinvestment Act, and line of business and geographic restrictions, competitors from nonbank financial service providers—such as insurance companies Prudential and Met Life, brokers like Merrill-Lynch and E.F. Hutton and large corporations like AT&T and Ford Motor Company—were not subject to the same amount of regulation. The above requirements, coupled with many additional regulatory and compliance rules, cost the industry $10.7 billion in 1991.[34] Sound economics and examples from telecommunications, airlines, freight, and banking industries indicate that maintaining unnecessary regulatory constraints on incumbents leads to significant societal costs. Regulatory policies must be forward looking: based on current and likely future market developments rather than on vestiges of a monopoly-provided system that no longer is present or relevant.

B. Pricing Flexibility Tools

There are many prescriptions in the Part 61 and 69 access regime that deny ILECs the flexibility needed to compete effectively against potential, nascent and established competition. These rules include the requirements to average rates geographically without regard to underlying costs, prohibitions on ILEC volume and term discounts (including customer-specific contracts), and delays in approval of new services, promotional offerings, and optional service packages. These constraints cause incorrect market signals to be sent to participants, hinder the establishment of efficient competition and increase the likelihood of inefficient and wasteful investment. In the remainder of this section, we discuss the benefits associated with the different forms of pricing flexibility.

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[33] In 1980, Congress passed the Staggers Act to deregulate the railroad industry and the Motor Carrier Act to deregulate the trucking sector.

[34] Robert G. Harris, "Toward Regulatory Symmetry in Local Exchange Services: Lessons From Financial Services and Freight Transportation," *Op. Cit.*

Rates for many carrier access services—including the subscriber line charge (SLC) and carrier common line charges (CCLC), local switching, transport and the newly-created primary interexchange carrier charges (PICC)—are geographically averaged, creating significant inefficiencies when costs vary geographically. Geographically-averaged rates cause prices in some areas to exceed their economic costs, while prices in other areas are below cost. Such pricing creates two different sorts of inefficiencies: (1) inefficient utilization of telecommunications resources, and (2) distorted competitive incentives. For example, in high cost areas where economic costs are likely to exceed prices, distortions occur because consumers are given a false signal to add lines even though the marginal benefit to the customer may be less than the incremental cost incurred. Competitive distortions occur due to the inability of competitors to compete with below-cost prices. In low cost areas, the opposite effect occurs. Because prices are higher than their economic costs, consumers are discouraged from adding lines even though their marginal benefit may be greater than the incremental costs incurred. Competitors are falsely encouraged to enter the market even though their incremental costs may be higher than the ILEC's.

Deaveraging carrier access service prices by geographic area and class of customer more closely aligns rates with the ILECs' costs and leads to efficiency improvements. Such deaveraging is especially important in the early stages of competition because efficient entry decisions should be made on the basis of economic cost, not distorted price signals. As observed in an earlier, related context,

> (t)here is no doubt that potential and actual entrants (such as MCI) have a strong incentive to rigidify the price responses open to an incumbent who is confronted with newly emerging competition. It seems clear that the staunchest advocates of full-cost pricing have been firms anxious to hobble their disquietingly effective rivals.[35]

In a world where UNEs can be used as a substitute for ILEC carrier access services as well as retail local exchange services, it is even more important to permit price deaveraging.

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[35] W. Baumol and J. Ordover, "Use of Antitrust to Subvert Competition," *Journal of Law and Economics*, May 1985 at 258.

Some states have approved rates for UNEs that are deaveraged based on urban, suburban or rural characteristics such as line density in a given area.[36] Not permitting ILEC retail and carrier access service prices to be deaveraged thus distorts competition between UNEs and ILEC services. Competitors can (i) target low cost areas where some or all customers pay higher rates than are justified by costs, (ii) purchase UNEs in that area at a cost-based rate and (iii) undercut the ILEC's rates. Without the ability to deaverage, the ILEC is unable to respond effectively.

This problem is compounded by the fact that UNEs are not priced differently for different types of end users—i.e., residential, single-line business, multiline business—despite the fact that the prices of the retail services with which they are used to compete do differ by type of end user. Moreover, the higher SLCs and PICCs charged to business customers, who have lower NTS costs on average, contribute to a subsidy from business to residential customers. Since UNEs are deaveraged, they can easily be used to arbitrage this subsidy away.

The benefits of deaveraging are clear. While in theory, deaveraging to the smallest unit available more closely aligns prices with costs, increased transactions costs associated with greater and greater deaveraging leads to an optimal level of deaveraging that is not at the smallest available unit. For example, the billing and metering costs necessary to deaverage down to each individual customer are likely to be prohibitive. Therefore, while deaveraging is consistent with competitive markets, ideally it should be left to the market to determine the optimal degree.

Permitting ILECs price flexibility to respond to potential and actual competition can generally lead to improvements in economic welfare. Such is the case with volume and term discounts that reflect cost efficiencies and with customer-specific contracts keyed to specific customer requirements. They promote efficient utilization of telecommunications resources by more closely aligning customer preferences with the firm's costs for production or delivery of

[36] Line density (access lines per square mile) is used as a proxy for cost per line. Higher line density is associated with lower costs due in part to shorter loop lengths.