Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Developing a Unified Intercarrier Compensation Regime	CC Docket No. 01-92

DECLARATION OF HOWARD A. SHELANSKI

Statement of Qualifications

I am Acting Professor of Law at the University of California at Berkeley. I received my B.A. from Haverford College in 1986, my J.D. from the University of California at Berkeley in 1992, and my Ph.D. in economics from the University of California at Berkeley in 1993. I have been a member of the Berkeley faculty since 1997. In 1998-2000 I was on leave from my faculty position to serve as a Senior Economist to the President's Council of Economic Advisers (1998-99) and then as Chief Economist of the Federal Communications Commission (1999-2000). I formerly practiced law in Washington, D.C. and served as a law clerk to Justice Antonin Scalia of the U.S. Supreme Court.

I teach and conduct research in the areas of telecommunications regulation, antitrust, and applied microeconomics. My recent publications include articles in the *Journal of Law, Economics and Organization*, the *Yale Journal on Regulation*, the *University of Chicago Law Review*, the *Journal of Law and Economics*, the *University of Chicago Legal Forum,* and the *Columbia Law Review.* I am co-author of the recently published legal textbook *Telecommunications Law and Policy* (Carolina Academic Press, 2001). I have served as a referee for a number of economics journals and am an editor of the *International Review of Law and Economics*. My C.V. is attached.

Introduction

The purpose of this affidavit is not to address the comparative merits of bill and keep versus calling-party-network-pays (CPNP) rules for local interconnection. It is, instead, to argue that whatever the benefits of bill and keep or CPNP for inter-carrier compensation for local traffic, it would be bad policy to implement either in the context of access charges. The following paragraphs will discuss several reasons why the access charge regime that is currently in place should not be disturbed in favor of either bill and keep or prescribed CPNP rates.

TELRIC or Other Rate Prescription Should Not Be Applied To Access Charges

1. It is important to recognize, first, that the policy for local interconnection should not dictate the policy for inter- or intrastate access charges. Interconnection in the local (or CMRS) context involves carriers that serve distinct customers cooperating so that carrier A's cusotmers can reach carrier B's customers. Carrier A has no relationship with the customers of carrier B, and carrier B's network is irrelevant to carrier A and its customers, unless those customers happen to call subscribers to carrier B (and vice versa). Moreover, when local carriers pass traffic back and forth, they are performing equivalent termination services for each other. Long-distance access differs. While local carriers terminate calls that are handed-off to them by long-distance carriers, long-distance networks do not in turn perform reciprocal termination services for local carriers. Long-distance carriers are instead providing calling services to end users, for

which local termination constitutes an essential input. Local interconnection is thus a reciprocal relationship of termination services between carriers, whereas long-distance service is a vertical relationship in which local termination is just an input into the long-distance carrier's provision of calling services to end users. There is no reason that the economics of local interconnection should be assumed identical to those of the very different relationship inherent in long-distance access.

2. Thus, while bill and keep may have desirable properties for inter-carrier compensation for local interconnection under some circumstances, there are significant challenges to be overcome before the Commission could consider applying it to access. Access charges have traditionally been used to provide a large proportion of ILECs' revenues. Any change to a bill and keep system would therefore involve a very substantial shift of recovery to end-user prices, with attendant controversies over customer impact and universal service concerns. And, as I explain below, artificially constraining recovery would not only harm ILECs, but could deter efficient, competitive entry as well. Since intrastate access charges are regulated by the states, there is also the problem of coordinating federal and state policy with respect to access charges, so as not to create unacceptable arbitrage between state and interstate access traffic.

3. These considerations weigh in favor of maintaining access charges on a CPNP basis, at least until the issues associated with bill and keep for access can be fully addressed. In the context of CPNP, there is no reason that the access regime recently adopted by the Commission, through the CALLS and MAG plans, should be reexamined now. Ordover

and Willig nonetheless propose that access rates should be reset prescriptively and that the standard for doing so should be some measure of forward-looking cost, such as TELRIC.

4. I believe that any new prescription of access rates would at this time be bad policy. As I have already discussed, there is no set of "perfect" CPNP rates that will address the concerns raised in the NPRM. More generally, the Commission should be seeking ways to make regulation less prescriptive, and less information-intensive. The Commission adopted price caps for ILEC access charges eleven years ago, precisely because it recognized that it did not have the information necessary to prescribe specific levels for each access charge element. Instead, it designed the price cap system to protect consumers where necessary, but also to provide incentives for efficiency and to elicit information about the relative levels of specific prices. In the years since, the Commission has relaxed price cap controls in those markets where it has found sufficient competition. As competition continues to develop, the Commission may need to maintain regulatory protection in certain markets, but it should be seeking the least intrusive means for doing so. Its methods should not depend on ascertaining detailed information about cost or demand in an attempt to prescribe specific rates, but should instead focus on establishing more general constraints that will promote efficient outcomes. For access, for the present, it might mean maintaining the current price cap regime adopted under the CALLS plan only until the Commission determines that sufficient competition exists to remove the caps.

5. But even if the Commission were to prescribe rates for access – which it should not— TELRIC would not be a reasonable standard on which to base those rates. In fact, TELRIC has several important drawbacks for pricing access of any kind. Notably, TELRIC does not capture the actual costs of originating or terminating traffic. Instead, TELRIC as interpreted by the Commission captures the forward-looking costs of a hypothetical firm containing the optimal network given today's technology. TELRIC will thus likely understate the costs any real-world firm, even one that efficiently upgrades and replaces its network, actually incurs to provide access on its network. TELRIC has been extremely controversial for its reliance on the costs of an idealized, hypothetical network. The United States Court of Appeals for the Eighth Circuit rejected TELRIC because of its hypothetical nature and the case is now pending before the Supreme Court. Numerous economists have criticized the Commission's TELRIC approach on the grounds that it would systematically under-compensate carriers for use of network elements and thereby lead to poor investment incentives for ILECs and inefficient entry decisions by CLECs.

6. Whatever the ultimate legal fate of TELRIC in the courts, it is the latter economic point about efficient investment decisions that is most important for access pricing. Access prices should provide incentives for incumbents to invest efficiently in their networks and for new firms to enter the market if they could provide access more efficiently than the incumbents do. But if access prices artificially understate the incumbents' true costs, then those prices will provide inaccurate signals to new entrants and will deter entry where it in fact would be efficient. Such inaccurate price signals will flow from any regulation

that risks prescribing charges that are below the actual costs of the carriers providing network access.

7. It is important to recognize that TELRIC cannot be justified on the basis that it replicates prices found in a competitive market, which is the objective Ordover and Willig argue (at page 6 of their affidavit) the Commission should seek to achieve. As applied to date, TELRIC has modeled forward-looking costs based on a hypothetically efficient network that would not, in fact, ever be found in long-run equilibrium, even under competitive conditions. To see that TELRIC models are unlikely to have any relation to prices that result under real competition, one need only to look at the market for long-distance telephone services, which is often heralded as being vigorously competitive. The average revenue per minute for long distance carriers appears much higher than the sum of access charges and the TELRIC of providing long-distance services.[1] TELRIC is both theoretically and empirically a poor proxy for competitive market outcomes and thus fails to do what Ordover and Willig argue that a proper pricing rule should do.

8. The difficulty of supplanting the current access charge regime becomes even more complicated when existing state regulation is taken into account. Before the Commission decides that it will abandon the existing per minute access charge regime in favor of a new, unified regime for inter-carrier compensation, it would be important to understand how that will affect intrastate regulation. Will it create untenable arbitrage opportunities?

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[1] According the Commission's Statistics of Common Carriers (August,2001) the average revenue per minute for interstate switched long distance services (excluding international services) is 11 cents per minute. Under the CALLS plan, interstate switched access charges are approaching 1.1 cents per minute (including both ends of a call), or about one tenth of the long distance price. See also Farrell and Hermalin at 5.

Will it create inefficient regulation to prevent arbitrage? Will it force changes in other regulations? Answering the likely interaction effects of proposed changes is important to understanding the efficiency effects of proposed rule changes. The Commission recognized this in its *Notice* where it said "any discrepancy in regulatory treatment between similar types of traffic or similar categories of parties is likely to create opportunities for regulatory arbitrage."[2] A unilateral federal movement of access charges may create arbitrage that undermines state regulatory goals and leads to ad hoc regulatory responses that, while perhaps defeating arbitrage, undermine cost recovery and possibly deter entry.

9. Given these hazards, the Commission should not extend TELRIC or other rate prescription to access charges. The current, recently adopted access charge regime should be left in place, and the Commission should avoid re-prescribing those rates in a manner that will require increased regulatory oversight, create additional uncertainty for incumbent carriers and potential entrants, and be likely to provide inefficient investment and entry decisions.

[2] Notice, para. 12.

Declaration

I, Howard Shelanski, declare under penalty of perjury that the foregoing is true and correct to the best of my knowledge. Executed on November 5, 2001.

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Education

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J.D. 1992; Order of the Coif
Senior Articles Editor, *California Law Review*

Haverford College, Pennsylvania
B.A. (history) with high honors, 1986
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Current Position

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Acting Professor of Law. Teaching areas include antitrust law, telecommunications law, regulated industries, and contract law.

Experience

Federal Communications Commission, Washington, D.C.
Chief Economist. 1999-2000.

President's Council of Economic Advisers, Washington, D.C.
Senior Economist, responsible for issues of industrial organization, competition policy, regulation, and trade, 1998-99.

Kellogg, Huber, Hansen, Todd & Evans, Washington, D.C.
Associate, telecommunications and general litigation practice, 1995-97.

Law Clerk to Justice Antonin Scalia, United States Supreme Court, 1994–95.

Law Clerk to Judge Louis H. Pollak, U.S. District Court, Eastern District of Pennsylvania, 1993-94.

Law Clerk to Judge Stephen F. Williams, United States Court of Appeals, D.C. Circuit, 1992-93.

Other

Speak French and Spanish;
Enjoy brewing beer, outdoor sports, and travel;
Admitted to the Bar in the District of Columbia and Pennsylvania.

Research & Publications

"Robinson-Patman Act Regulation of Intraenterprise Pricing," (comment), 80 *California Law Review* 247 (1992).

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"From Sector-Specific Regulation to Antitrust Law for U.S. Telecommunications: The Prospects for Transition," working paper, July 2001.

"Regulation in an Evolving Network Industry: the Case of Broadband Communications," working paper, October 2001.