Reforming the UNE Regime Through Price Cap Regulation

Introduction

The proposed acquisition of AT&T and MCI by their principal national rivals, SBC and Verizon, symbolizes the collapse of local competition and, if approved, will further accelerate its decline. It is not the purpose of this paper, however, to add to the growing body of evidence that explains why these mergers should be denied. Rather, this paper identifies a critical reform needed for CLEC competition to succeed in an environment where its largest champions, AT&T and MCI, have been absorbed into a re-emerging "Bell System" managed and operated by SBC and Verizon.[1]

The effect of these mergers on local competition cannot be ignored. The federal Act, with its reliance on arbitration and the private enforcement of wholesale obligations and contracts, requires some semblance of parity between entrant and incumbent. In effect, the Act privatized the regulation of the RBOCs' wholesale services, shifting much of the foundational review of RBOC wholesale offerings to their CLEC competitors. The potential elimination of the "top-layer" of the competitive pyramid dramatically reduces the resources available for the competitive sector to continue in this role.

The federal Act did more than attempt to reorganize local telephone markets, it also effected a subtle shift in the regulatory role of government. For all practical purposes, the Act privatized responsibility for the regulation of the RBOCs' wholesale services with their competitive customers, relying on the competitive entrants to arbitrate and enforce their rights.

What is needed is fundamental reform – reform consistent with the Act and federal rules, but reform nonetheless. The concept proposed by this paper involves the application of a proven idea to a new area – namely that the prices for the RBOCs' wholesale offerings be governed under an incentive framework (i.e., price caps) in the same way that its retail and access offerings have been regulated in the past. Such a system will assure *stable* access to the RBOC network in an efficient, predictable and commercially meaningful manner.

As new technologies and, hopefully, new networks slowly emerge, a price cap regime provides an appropriate transitional path to a lessened level of regulation. In addition to greatly simplifying the wholesale regulation of the RBOC, price caps are a recognized transitional path to a competitive market.[2] As alternatives to the RBOC network slowly emerge, the price cap mechanism balances flexibility with non-intrusive oversight and is well-suited to markets in transition.

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1 Although this paper addresses the importance of price cap regulation as a means to restore stability to the RBOCs' wholesale offerings, the paper should not be interpreted as suggesting, in any way, that the acquisitions of AT&T and MCI are in the public interest and should be approved.

2 As the FCC has explained, "…price caps act as a transitional regulatory scheme until the advent of actual competition makes price cap regulation unnecessary." *Special Access NPRM,* Federal Communications Commission, WC Docket No. 05-25, January 31, 2005, ¶11.

The Pending Resource Imbalance

The Supreme Court characterized the basic goal of the federal Act as being "to reorganize markets by rendering … monopolies vulnerable to interlopers," giving "aspiring competitors every possible incentive to enter local retail telephone markets."[3] The federal Act did more than attempt to reorganize local telephone markets, it also effected a subtle shift in the regulatory role of government. For all practical purposes, the Act *privatized* responsibility for the regulation of the RBOCs' wholesale services with their competitive customers, relying on the competitive entrants to arbitrate and enforce their rights.

The proposed acquisitions of AT&T and MCI violate a fundamental assumption underlying the Act – that is, that a reasonable resource balance would exist between entrants and incumbents so that the creative tensions of negotiation and arbitration could produce just and reasonable wholesale arrangements.

Prior to passage of the federal Act, state regulation was focused at the *retail* level, with an emphasis on retail prices and quality of service. The principal resources used to police RBOC behavior were publicly (or utility) funded: commission staff, formal advocacy departments, and other state-level consumer utility advocate organizations. As regulation moved from traditional rate-base/rate-of-return approaches to more flexible forms of price regulation, these publicly-funded resources continued to monitor earnings, service quality and other issues important to retail regulation.

The federal Act, however, shifted the focus of regulation from the *retail* level, where competition was expected to take root, to the *wholesale* level beneath it.[4] The wholesale tools adopted by Congress were comprehensive – resale of the incumbent's services, access to network elements at cost based rates, and, for RBOCs wanting to offer long distance services in-region, the added insurance of the competitive checklist. In addition to its shifting of regulatory emphasis from the retail to wholesale levels, however, the Act also shifted the principal responsibility for regulatory effort from the public sector to the private sector. In the wholesale scheme created by the Act, the primary activities of wholesale regulation – i.e., the creation of open cost models, the development of performance penalty plans, the litigation needed to establish and enforce access rights, as well as the monitoring of wholesale offerings – are substantively managed by competitors.[5]

In practical terms, SBC and Verizon are acquiring their regulators, at least with respect to wholesale services.

[3] *Verizon Communications, Inc. v. FCC*, 535 U.S. 467, 152 L. Ed. 2d 701, 122 S. Ct. (2002).

[4] The Supreme Court recognized that the goal of the federal Act was competition at the retail level, noting in *Verizon* that the Act had been "…designed to give aspiring competitors every possible incentive to enter local retail telephone markets, short of confiscating the incumbent's property." The path to retail competition chosen by the Act was regulation at the wholesale level, requiring the incumbents to open their networks to competitors under legal mandate and regulatory supervision.

[5] This is not to suggest that state commissions did not also devote substantial resources to fulfilling their duties under the federal Act. The state commission's role adjudicating disputes between entrants and the RBOC, however, is much different than its prior role as direct regulator of the RBOCs' retail activities. This adjudicatory role depends in the first instance upon the creative tension between entrant and incumbent, and the private resources committed to the regulatory process by both.

Critically, the proposed acquisitions of AT&T and MCI violate a fundamental assumption underlying the Act – that is, that a reasonable resource balance would exist between entrants and incumbents so that the creative tensions of negotiation and arbitration could produce just and reasonable wholesale arrangements. At the end of 1995, when Congress decided to rely on the negotiation/arbitration process as the mechanism to create viable wholesale offerings, this reasonable resource balance did exist between the monopoly and competitive sectors of the industry.

Table 1: Incumbent-Competitor Resource Balance at Act Passage[6]
(1995 $ millions)

Incumbent LEC Sector			Competitive Sector[7]		
Company	**Revenues**	**Employees**	**Company**	**Revenues**	**Employees**
GTE[8]	$19,957	85,000	AT&T	$79,609	299,300
BellSouth	$17,886	87,571	MCI	$15,265	50,367
Bell Atlantic	$13,430	61,800	WorldCom	$3,639	7,500
Ameritech	$13,427	65,345			
NYNEX	$13,407	65,800			
SBC	$12,670	59,300			
US West	$9,284	n/a			
Pacific Telesis	$9,042	48,889			
Total	**$109,103**	**473,705**	**Total**	**$98,699**	**357,167**

As the above table shows, at the time Congress was crafting the federal Act, resources were roughly balanced between the monopoly and competitive sectors. The largest expected local entrants were established interexchange carriers,[9] well financed and (at least presumably) positioned to become effective local competitors. The single largest carrier was AT&T, which at the time included the resources of NCR and (what would ultimately become) Lucent. The regulatory model adopted by Congress, with its heavy reliance on bilateral negotiation and arbitration, reflected the resource balance that existed at the time.

In the time since the Act passed, however, the resources available to the competitive sector have declined, while the incumbents have consolidated to concentrate the resources available to them. Although the RBOCs have *twice* promised acquisitions that were claimed to create the necessary scale to compete out-of-region,[10] the reality has been the emergence of two super-RBOCs that dominate the industry.

6 Source: 1995 10K Reports.

7 In addition to these large competitors, there were a handful of much smaller entrants with comparatively modest revenues and numbers of employees.

8 GTE's domestic employees only.

9 A fourth interexchange carrier (Sprint) is also an incumbent LEC and has not been included in the above table as either a member of the competitive or monopoly sectors of the industry.

10 Both SBC (when it acquired Ameritech) and Verizon (when it acquired GTE) claimed that these mergers would provide them the scale they needed for out-of-region entry.

Table 2: Incumbent-Competitor Resource Balance – Pre-Merger[11] (2004 $ millions)[12]

Incumbent LEC Sector			Competitive Sector[13]		
Company	**Revenues**	**Employees**	**Company**	**Revenues**	**Employees**
Verizon	$71,283	210,000	AT&T	$30,537	47,600
SBC	$59,648	162,700	MCI	$20,690	40,400
BellSouth	$27,910	62,564	Level 3	$3,712	4,500
Qwest	$13,809	41,000	XO	$1,300	5,000
			McLeod	$716	2,400
			Broadwing	$672	1,661
			Time Warner	$653	1,986
			ITC^DeltaCom	$583	2,050
			Talk	$471	1,200
			Covad	$429	1,141
			US LEC	$356	1,065
			Trinsic	$251	765
			Eschelon	$158	1,139
			PacWest	$124	373
Total	**$172,650**	**476,264**	**Total**	**$60,653**	**111,280**

As Table 2 demonstrates, the combined effect of RBOC consolidation and the difficulties experienced by competitors has lead to an ever-tilting resource imbalance favoring the incumbent. For example, at the time the Act passed, the RBOCs had 53% of the total industry revenue; by 2004, their share had increased to almost 75%. Similarly, the RBOCs employed 57% of the total employees in 1995; by 2004, that had increased to 81%.

The resource imbalance that exists today (as shown above), however, is manageable compared to the imbalance that will result if the resources of AT&T and MCI shift from the competitive to monopoly sectors. Of the total estimated 2004 competitive revenues of just over $60 billion, some $50 billion are revenues earned by AT&T and MCI. In practical terms, SBC and Verizon are acquiring their regulators, at least with respect to wholesale services. The Act's reliance on the creative tension between incumbent and entrant -- with the requisite arbitration by state utility commissions -- would be irreparably harmed, rendering privately-funded arbitrations, cost-proceedings and performance monitoring systems far less effective (if not irrelevant).

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11 Source: 2004 10K Reports.

12 Revenues for SBC and BellSouth adjusted to reflect proportional ownership of Cingular Wireless (60% SBC/40% BellSouth).

13 Listing includes competitive carriers that have reached sufficient size to (at least, at one time) attract public capital. Because the focus of this paper concerns the regulatory reforms needed to provide stable access to RBOC facilities, the table does not include cable-based entrants or wireless carriers because such carriers do not rely extensively on RBOC-facilities to provide service.

Table3: Incumbent-Competitor Resource Balance – Post-Merger
(2004 $ millions)

Incumbent LEC Sector[14]			Competitive Sector		
Company	**Revenues**	**Employees**	**Company**	**Revenues**	**Employees**
Verizon	$91,973	250,400	Level 3	$3,712	4,500
SBC	$90,185	210,300	XO	$1,300	5,000
BellSouth	$27,910	62,564	McLeod	$716	2,400
Qwest	$13,809	41,000	Broadwing	$672	1,661
			Time Warner	$653	1,986
			ITC^DeltaCom	$583	2,050
			Talk	$471	1,200
			Covad	$429	1,141
			US LEC	$356	1,065
			Trinsic	$251	765
			Eschelon	$158	1,139
			PacWest	$124	373
Total	**$223,877**	**564,264**	**Total**[15]	**$9,426**	**23,280**

Whether the mergers are the cause of the resource imbalance identified above, or merely the culminating event, is not relevant. Either way, regulators can no longer rely on the efforts of AT&T and MCI in keeping the RBOCs' wholesale offerings viable. In order for the remaining competitors to avoid a similar fate, regulators must make sure that the Act's market opening provisions are meaningful, with <u>reasonable prices</u> and <u>stable terms</u>, and without the threat of perpetual erosion. A properly structured price regulation plan can provide that certainty.

State Commission Authority to Adopt
<u>Price Cap Regulation of RBOC Wholesale Offerings</u>

One of the virtues of price cap regulation is that it can be structured to apply to *all* of the RBOCs wholesale offerings, including those required under §271 of the Act. In the sections that follow, we explain the two categories of network elements that a price cap plan should address – i.e., those required under §251 of the Act and those required under §271. Second, we explain that a state commission's pricing authority over §251 and §271 network elements derives from its role as arbiter under §252 of the Act.[16] Finally, we explain that price regulation plans are an

14 Table 3 combines the revenues and employees of AT&T and MCI with those of SBC and Verizon (respectively). This simple calculation partially overstates revenues (because some of the RBOCs revenues are derived from services provided to AT&T and MCI) and employees (because the mergers will result in layoffs). However, for the purpose of the points made in this paper, the calculation does demonstrate the relative size of the incumbent and competitive sectors of the industry post-merger.

15 Contrasting the "total resources" of the incumbent and competitive sectors understates the RBOC's advantage because such a large percentage of the RBOC's resources are concentrated in a few firms, thereby reducing the costs of coordination. In contrast, CLEC resources are spread across many firms and frequently extend across multiple-RBOC regions.

16 Because §271 requires that §271 network elements be offered in interconnection agreements approved under §252 of the Act, a state commission has the same responsibility to apply the FCC-directed pricing rules for §271 elements as it does for §251.

acceptable method to maintain cost-based rates and that there are no federal rules prohibiting the state commission from adopting such plans to regulate wholesale offerings, including UNEs.

The Twin Unbundling Obligations of the Federal Act

As indicated above, there are two categories of wholesale offerings required under the federal Act -- those required by §251 of the Act and, because each RBOC has chosen to provide long distance services, those separately required by §271. Although the FCC must find impairment to require that a network element be unbundled under §251 of the Act, the network elements required by the competitive checklist in §271 are required as a clear *quid quo pro* for the authority to provide long distance service. As such, §271 network elements must be offered whether or not the FCC believes that competitors would be impaired without them.[17]

> ***In order for the remaining competitors to avoid the fate of AT&T and MCI, regulators must make sure that the Act's market opening provisions, most especially §271, are meaningfully available, with reasonable prices and stable terms, and without the threat of perpetual erosion.***

The primary difference between §251 and §271 network elements is the price at which they must be offered. Network elements unbundled in accordance with §251 of the Act must be priced at TELRIC, while those required under §271 of the Act are held to a (potentially) more liberal pricing standard that requires rates to be just, reasonable, nondiscriminatory and must provide meaningful access:

> Thus, the pricing of checklist network elements that do not satisfy the unbundling standards in section 251(d)(2) are reviewed utilizing the basic *just, reasonable, and nondiscriminatory rate standard*…. Application of the just and reasonable and nondiscriminatory pricing standard of sections 201 and 202 advances Congress's intent that Bell companies provide *meaningful access to network elements*.[18]

Because the RBOCs' §271 requirements had duplicated parallel obligations under §251, it has not been necessary (until now) to establish the precise terms, conditions and prices for §271-compliant offerings of network elements.

It is clear that the regulators should expect the RBOCs to try and game their §271 obligations, agreeing to "offer" the required elements, but only under conditions that render them economically useless. For instance, we expect the RBOCs will claim that they need not combine §271 network elements with other facilities, attempting to exploit an odd semantic construction in federal rules to evade a statutory duty. Under federal rules, the term combining is used to describe connecting facilities when both elements are required under §251 of the Act; when a §251 network element is being connected to any other wholesale offering (such as a §271

[17] The §271 elements include all the basic components of local exchange service: loops, switching, transport and signaling. The RBOCs' continuing obligation to provide access to these elements (even where the FCC has not found impairment) is well established. *See* TRO ¶ 659 (emphasis added).*In the Matter of Petition for Forbearance of the Verizon Telephone Companies Pursuant to 47 U.S.C. § 160(c),* WC Docket 01-338 *et al.,* Memorandum Opinion and Order at ¶ 7 (rel. Oct. 27, 2004) ("*Broadband Forbearance Order*") (footnotes omitted).

[18] *TRO* ¶ 663 (footnotes omitted).

network element), however, the term commingling is used to describe the arrangement.[19] Because of the use of different terms, it is true that the RBOCs need not technically *combine* §271 network elements; however, the RBOC must *commingle* §271 elements with elements required by §251, which means that the obligation remains, even if the labeling has changed.[20]

Consequently, the only dimension of a network element that changes when it ceases to be required under §251 – but is still required to be offered under §271 – is its price. While offered under §251, the element's price must be tied to TELRIC; once moved to §271, the price is governed under the potentially more liberal "just and reasonable" standard.

State Commissions are Responsible for Setting Wholesale Rates

State commissions have the same responsibilities establishing rates for §271 network elements as they have for §251 elements. That is, the states are charged with applying the pricing *guidance* adopted by the FCC to the particular circumstances in their state. Although §271 is a voluntary set of obligations (that is, it only applies to an RBOC that desires authority to provide in-region long distance services), the Act is quite clear on *what* must be offered and *how*. The *what*, of course, are the elements separately listed in the competitive checklist; the *how* is through interconnection agreements, approved by state commissions in accordance with §252.[21]

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19 *See TRO* ¶ 597, emphasis added (below) and 47 CFR 51.5:

> By commingling, we [the FCC] mean the connecting, attaching, or otherwise linking of a UNE, or a UNE combination, to one or more facilities or services that a requesting carrier has obtained at wholesale from an incumbent LEC pursuant to any method other than unbundling under Section 251(c)(3) of the Act, or the combining of a UNE or UNE combination with one or more such wholesale services.

20 The FCC has determined that prohibitions against unjust and unreasonable practices under Sections 201 and 202 require RBOCs to support commingled offerings (*TRO* ¶ 591 and *TRO* ¶ 597):

> Thus, we find that a restriction on commingling would constitute an "unjust and unreasonable practice" under 201 of the Act, as well as an "undue and unreasonable prejudice or advantage" under section 202 of the Act. Furthermore, we agree that restricting commingling would be inconsistent with the nondiscrimination requirement in Section 251(c)(3).
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> ***
>
> In addition, upon request, an incumbent LEC shall perform the functions necessary to commingle a UNE or a UNE combination with one or more facilities or services that a requesting carrier has obtained at wholesale from an incumbent LEC pursuant to a method other than unbundling under Section 251(c)(3) of the Act.

We note that one RBOC (SBC) has testified that its "commingling" and "combining" obligations are essentially identical (*see*, Niziolek Direct Testimony, Case No. PUD 200400492, Oklahoma Corporation Commission, page 31, parenthetical omitted):

> The FCC used essentially the same language in imposing the "commingling" obligation on ILECs as it used in imposing the UNE combining obligation – "perform the functions necessary to." This clearly indicates that an ILEC's commingling obligations are of similar scope as its UNE obligations.

21 Obviously, it would have made no sense for Congress to establish the very specific additional requirements of the competitive checklist, but then leave it to the RBOC's discretion as to how the safeguard should be implemented.

The federal Act requires that §271 network elements be offered in interconnection agreements approved under §252 of the Act in the very same way that §252 is used to arbitrate and approve agreements that address elements required under §251. Section 271(c)(2)(A) clearly requires that the competitive checklist must be satisfied through interconnection agreements (or a statement of generally available terms ("SGAT") stating:

> (A) AGREEMENT REQUIRED - A Bell operating company meets the requirements of this paragraph if, within the State for which the authorization is sought—
>
> (i)(I) such company is providing access and interconnection pursuant to one or more agreements described in paragraph (1)(A) [Interconnection Agreement], or
>
> (II) such company is generally offering access and interconnection pursuant to a statement described in paragraph (1)(B) [an SGAT], and
>
> (ii) such access and interconnection meets the requirements of subparagraph (B) of this paragraph [the competitive checklist].[22]

Moreover, the reference to "agreements described in paragraph (1)(A)" ties compliance with the competitive checklist to Section 252.[23] Section 271(c)(1) states:

> (1) AGREEMENT OR STATEMENT- A Bell operating company meets the requirements of this paragraph if it meets the requirements of subparagraph (A) or subparagraph (B) of this paragraph for each State for which the authorization is sought.
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> > (A) PRESENCE OF A FACILITIES-BASED COMPETITOR- A Bell operating company meets the requirements of this subparagraph if it has entered into one or more binding agreements that have been approved under section 252 specifying the terms and conditions under

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[22] 47 U.S.C. § 271(c)(2)(A). (emphasis added).

[23] The requirement that checklist items must be offered in §252 interconnection agreements was cited by a Federal District Court upholding fines imposed by the Minnesota Commission on Qwest for failing to file certain interconnection agreements:

> Citing the fair notice doctrine, Qwest argues additionally that it should not be penalized for failing to file some of the twelve ICAs [interconnection agreements] because it did not know which agreements were subject to the Act's filing requirement.
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> ***
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> … despite the absence of a definition [for the term interconnection agreement] in the Act, other sources outlined the scope of §252 and provided notice. For example, §271 includes a comprehensive checklist of items that must be included in ICAs before an ILEC may receive authority to provide regional long distance service. This list reveals that any agreement containing a checklist item must be filed as an ICA under the Act.

Qwest Corporation v. Minnesota Public Utilities Commission, 2004 WL 1920970, at *7 (D. Minn. 2004) (citations omitted) (emphasis added).

> which the Bell operating company is providing access and interconnection to its network facilities for the network facilities of one or more unaffiliated competing providers of telephone exchange service (as defined in section 3(47)(A), but excluding exchange access) to residential and business subscribers.[24]

Although the FCC adopted a different pricing *standard* to apply to §271 prices, it did not – and could not – abandon the central structure of the Act in which the arbitration of specific rates is a task assigned to the states.[25]

Both the TELRIC and Just and Reasonable Standards Can Be Satisfied by an Appropriately Structured Price Cap Regulation Plan

Because the RBOC wholesale offerings are judged by separate rate standards, it is important that a price regulation plan be able to satisfy both. Price regulation plans consist of two basic steps. First, rates must be initialized. Second, a plan must include parameters (e.g., an annual inflation factor and productivity offsets) to ensure continuing compliance during the plan.

Rate Initialization

Initializing rates for §251 network elements is straight-forward. The states have already conducted all the cost proceedings needed to initialize rates at TELRIC-based levels. As such, no additional analysis is needed; the existing prices can be used as the starting point for a price regulation plan.

The initial rates for §271 network elements pose a different issue because no such "just and reasonable" rates have yet been established. Prior to the FCC's adoption of the *TRRO*, the obligations of §271 essentially duplicated identical obligations under §251. As a result of the *TRRO*, however, there are now a number of key network elements that will no longer be required under §251, but for which §271-compliant, just and reasonable rates are needed.[26]

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24 47 U.S.C. § 271(c)(1)(emphasis added).

25 The United States Supreme Court affirmed this division of responsibility, noting:

> . . . 252(c)(2) entrusts the task of establishing rates to the state commissions . . . . The FCC's prescription, through rulemaking, of a requisite pricing methodology no more prevents the States from establishing rates than do the statutory 'Pricing standards' set forth in 252(d). It is the States that will apply those standards and implement that methodology, determining the concrete result in particular circumstances. (*AT&T Corp. vs. Iowa Utilities Board*, 525 U.S. 366, 385, 119 S.Ct. 721, 732 (1999), emphasis added).
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> ***
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> The approach [in the federal Act] was deliberate, through a hybrid jurisdictional scheme with the FCC setting a basic, default methodology for use in setting rates when carriers fail to agree, but leaving it to state utility commissions to set the actual rates. (*Verizon Communications, Inc. v. FCC*, 535 U.S. at 489).

26 Specifically, the state commissions must establish initial rates for local switching, and high-capacity loops and transport facilities (once it is clearly determined where the precedent conditions that permit RBOC to withdraw §251 access have been satisfied).

For these §271 elements, the simplest approach would be to adopt as initial §271 rates the transitional prices adopted by the FCC. The Missouri Commission recently established interim §271 prices equal to the higher transition rates established by the FCC.[27] Presumably the FCC believes these prices to be just and reasonable; therefore initializing rates at these levels is consistent with federal policy.

Ongoing Compliance

Having initialized wholesale rates at existing and/or transitional levels, the key issue turns to relying on the formulistic approach of a price cap plan to ensure that rate levels remain at just and reasonable (and, for §251 elements, TELRIC-based) levels. It is important to note that while the FCC's rules require that prices satisfy the appropriate pricing standard, the rules do not detail any particular approach to maintaining that relationship over time.

Federal rules are silent as to how changes in TELRIC-based rates should be reviewed. There are no rules concerning how frequently such rates should be adjusted, or whether an automatic formula may apply.[28] To the contrary, the FCC recognizes that the timing of full UNE cost proceedings is completely within the state's discretion, and has requested comment on whether the FCC itself should mandate a price-cap system.[29]

Far from being opposed to relying on price caps as a means to sustain cost-based rates, the FCC has long held that the system accomplishes precisely that goal. When the FCC first embraced price regulation as a regulatory system,[30] it confronted this very question, concluding unequivocally that a price cap system can be designed to ensure cost-based price changes:

> We proposed to adjust price caps each year according to a predetermined formula that is designed to ensure a continuing nexus between tariffed rates and the underlying cost of providing service.[31]
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> A carrier's services are grouped together in accordance with common characteristics, and the weighted prices in each group are adjusted annually pursuant to formulas designed to ensure that rates are based on cost …[32]

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[27] Arbitration Order, Public Service Commission of Missouri, TO-2005-0336, July 11, 2005.

[28] The FCC requested comment on whether the FCC itself should adopt a price-regulation framework in 1996 (in the context of its original Interconnection Order) and concluded that no such rules were needed at the federal level. *First Report and Order, Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, Federal Communications Commission, CC Docket 96-98, August 8, 1996, ("*Local Interconnection Order"*), ¶ 838.

[29] In the Special Access NRPM, the FCC asked:

> If the use of productivity factors to adjust rates periodically is feasible, should it be mandatory? Or should states <u>retain the ability to conduct a full UNE-pricing proceeding at their discretion</u>?

Notice of Proposed Rulemaking, Federal Communications Commission, WC Docket No. 03-173, September 15, 2003, ("*TELRIC NPRM*"), ¶ 140, emphasis added.

[30] *Report and Order and Second Further Notice of Proposed Rulemaking*, Federal Communications Commission, CC Docket No. 87-313, April 17, 1989 ("First Price Cap Order").

[31] *First Price Cap Order*, ¶ 8.

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> … the foundation of the price cap regulatory approach is to ensure that rates follow costs, while creating incentives to reduce costs…[33]

The FCC's conclusion with respect to the ongoing nexus between rates and costs is particularly important because that nexus is central to *both* the §251 and §271 rate standards, including the just and reasonable standard. Although the traditional "just and reasonable" rate standard is somewhat more flexible than the TELRIC cost-standard, that does not mean that the standard is divorced from cost. To the contrary, the "just and reasonable" standard has generally been interpreted as defining a range of *cost*-related prices:

> The Communications Act requires that rates be just and reasonable and not create unreasonable discrimination or undue preference. Sections 201(b) and 202(a), 47 U.S.C. §§ 201(b), 202(a). <u>Costs are traditionally and naturally a benchmark for evaluating the reasonableness of rates</u>, because cost-based rates both deliver price signals which contribute to efficient use of the networks and generally distribute network costs to the customer who causes those costs."[34]

Over time, as regulation has adapted to changing cost conditions, the two constants of the "just and reasonable" standard have been that (1) the touchstone to judge a rate is <u>cost</u> and (2) the view that just and reasonable encompasses a <u>range</u> of rates. These concepts permeate the record of FCC decisions, including those decisions that granted temporary deviations from cost.[35] As the Supreme Court summarized when it evaluated the reasonableness of TELRIC:

> What is remarkable about this evolution of just and reasonable ratesetting, however, is what did not change. The enduring feature of ratesetting from *Smyth v. Ames* to the institution of price caps was the idea that calculating a rate base and then allowing a fair rate of return on it was a sensible way to identify a range of rates that would be just and reasonable to investors and ratepayers.[36]

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32 *First Price Cap Order*, ¶ 38.

33 *First Price Cap Order*, ¶ 865

34 Memorandum Opinion and Order, Investigation of Special Access Tariffs of Local Exchange Carriers, CC Docket 85-166, Adopted October 13, 1988, Released December 1, 1988, 4 FCC Rcd. No. 12, ¶ 32, emphasis added.

35 For instance, the FCC once permitted the RBOCs to strategically price special access services, due to the "dislocations" of the AT&T divestiture and the fear of bypass from high initial access rates. Even then, however, the FCC's approach was to "bracket" allowed pricing relationships in an effort to reflect costs:

> As the Commission found in the *Strategic Pricing Order*, the six to one ratio represents the most likely approximation of the cost relationship between HiCap and VG services based on the record. The 4 to 8 range should be broad enough to encompass a "cost based" rate that might be produced by any rational cost allocation methodology used by an exchange carrier in the near future.

Order on Reconsideration, Investigation of Special Access Tariffs of Local Exchange Carriers, CC Docket 85-166, Adopted November 28, 1989 Released January 19, 1990, 5 FCC Rcd. No. 2, ¶ 73.

36 *Verizon* at 481.

Adopting a UNE price regulation regime patterned after the FCC's price regulation scheme should ensure rates for both §251 and §271 elements continue the important nexus to cost.

Significantly, adopting a UNE price regulation regime patterned after the FCC's price regulation scheme should ensure rates for both §251 and §271 elements continue the important nexus to cost. The basic role of the price regulation formula (i.e., an inflation rate reduced by expected productivity) is to act as a proxy for changes in current costs. Because the formula is intended to be a proxy for the change in current costs, it can be applied equally well *either* to embedded costs or to TELRIC-based rates. The difference between the two standards is important only when the initial rates are established, but it is not relevant to measuring changes in current costs.[37] If a price regulation plan reasonably tracks gains in the productivity of current technology, then that formula would maintain a reasonable nexus between prices and TELRIC costs as well.[38]

Conclusion

The fundamental intent of the federal Act was to extend the nation's experience enjoying the benefits of long distance competition to local markets. The federal Act has not been repealed, and this goal remains as important today as when the Act was passed.

What has changed is that the RBOCs have achieved a much greater concentration of economic power than when the Act was passed, while the competitive sector has struggled. The resource balance so critical to the Act's preferred negotiation and arbitration scheme is no longer in place.

Fortunately, a time-tested method, fully consistent with the Act, is available to ensure competitors obtain the stable and meaningful access to RBOC facilities that the Act contemplated. That method is price caps.

The time has come for state commissions to look to establishing price cap systems to regulate network access required under §251 and §271 of the Act.

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37 TELRIC-based rates reflect currently available technology, while embedded costs reflect prior technologies. Price-cap formulas are intended to track changes in current costs and thus would reasonable measure changes in the costs of currently available technology.

38 Moreover, patterning a state established price cap plan on the FCC price cap system makes sense because the facilities used to provide access services – *i.e.*, local loops, switching and transport – are the same facilities that the RBOC use to provide wholesale network elements. Consequently, the same rationale that supports applying these factors to the RBOC's access services can be used to govern changes in network elements prices.