BEFORE THE FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

RE: In the Matter of

Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers (WC Docket No. 03-173)

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COMMENTS OF THE :
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About the Competitive Enterprise Institute

The Competitive Enterprise Institute is a nonpartisan policy analysis organization, dedicated to the principles of limited constitutional government and free enterprise. The Institute is a nonprofit educational foundation, concerned with the welfare of consumers and the economy as a whole as opposed to one particular company or industry sector. Solveig Singleton, the author of these comments, is a lawyer and senior analyst with the Competitive Enterprise Institute. Her specialty is telecommunications and e-commerce

Summary

The FCC's Notice questions several aspects of the present TELRIC regime. CEI's comments will focus on four of the problems the FCC raises, in addition to pointing out others with bearing on the best solutions. Specifically, we address

- The tension in TELRIC between the assumption that rates should reflect a state of monopoly for some purposes, and a state of facilities-based competition for others; more generally, the need for more "reality" in TELRIC accounting.
- The "black box" nature of TELRIC and the inconsistency between different state TELRIC regimes.
- The need for accountability in TELRIC cost proceedings, which the FCC expresses as a concern for transparency and verifiability.
- The question of how the FCC will know if it succeeds in its goal of making TELRIC cost proceedings simpler and more accurate.

In the course of discussing these issues, we raise several problems with TELRIC proceedings that will affect and limit the available solutions. These include 1) the high rate of appeal of ILEC/CLEC arbitration proceedings that makes recourse to TELRIC inevitable and 2) "Gaming" and political factors in TELRIC proceedings.

At the end of the day, no regulation can substitute for the market process. The solutions we suggest the FCC consider, while in some respects unsatisfactory, are intended to counterbalance TELRIC's worst flaws. For example, the FCC might require the state to defer to or at least refer to cost or access price figures developed in universal service, tax, or arbitration proceedings, or as revealed by actual builds of real networks (including CLEC, wireless, or cable networks). As the FCC notes, cost figures from other proceedings are in some respects based on assumptions inconsistent with TELRIC. But distortions introduced thereby would almost certainly be less than those presently introduced by political factors and just plain errors.

Comments of the Competitive Enterprise Institute: TELRIC

I. The Very Serious Problems with TELRIC.

The Supreme Court has upheld the FCC's choice of TELRIC as a pricing method for unbundled access. Despite this decision, the FCC is right to ask fundamental questions about its TELRIC regime. Its victory was largely based on deference, not economic substance. For good or ill, the Court was reluctant to tangle with the economics of telecom networks at the level of detailnecessary to second-guess the FCC. Since the Supreme Court's decision, however, several red flags have popped up that it is indeed time to take a close look at TELRIC. These include the crisis in telecommunications capital markets (attributed by many Wall Street analysts in part to TELRIC miss-estimates of cost) and the abandonment of access lines, not to mention the slew of economist's articles critiquing TELRIC. While no regulatory regime can substitute for a real market process, too many investment decisions in the telecom world have been skewed too far out of wack for the FCC to fail to take action.

A. Conflicting Assumptions Within TELRIC; Irrelevance to Real Networks

The FCC's Notice states that, "we propose to simplify TELRIC pricing, while simultaneously improving the accuracy of its pricing signals, by resolving one of the key internal tensions that mark its current application: the assumption that for some purposes rates should reflect a market with widespread facilities-based competition but, for other purposes, rates should reflect a market with a single dominant carrier. We seek comment on an approach that bases UNE prices on a cost inquiry that is more firmly rooted in the real-world attributes of the existing network, rather than the speculative attributes of a purely hypothetical network."[1] Further on, the FCC notes that, "TELRIC is based on the assumption that competition would constrain the value of an incumbent LEC network and the prices that could be charged for that network. In other words, the "cost" of the element for purposes of section 252(d)(1) equals the price that an incumbent LEC would be able to charge for an element in a competitive market."[2] At the same time, "the cost of a UNE should be calculated based on the cost of ubiquitous deployment of the most efficient technology currently available."[3] So the hypothetical TELRIC network enjoys all the economies of scale of a omnipresent yet super-efficient monopolist, while at the same time it is forced into economies of cost by its facilities-based competitors.[4]

But as the FCC further notes, in the real world, firms do not instantly replace all their facilities with every new improvement in technology.[5] That is, to put it another way, the standard set by TELRIC is of no particular relevance to the problems facing today's networks; it cannot provide the correct investment incentives. Some day, a perfectly efficient future network that provides the same services as today's may exist; but one may not directly regulate such a creature into existence without bypassing the process of learning, experimentation, and discovery that is the root of market efficiency. Put another way, the fundamental flaw of cost-based pricing standards in general and TELRIC in particular is that it seeks efficiency in a market result rather than a market process.

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[1] Federal Communications Commission, Notice of Proposed Rulemaking, Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements, September 15, 2003, ¶ 4 (hereinafter *Notice*).

[2] *Notice*, ¶ 16.

[3] *Notice*, ¶ 49.

[4] *Notice*, ¶ 51 ("Simultaneously assuming a market inhabited by multiple competitors and one with a ubiquitous carrier with a very large market may work to reduce estimates of forward-looking costs below the costs that would actually be found even in an extremely competitive market.")

[5] *Notice*, ¶¶ 50-51.

The FCC seems to recognize this point in the Notice,[6] but is nonetheless unwilling at this time to overthrow TELRIC altogether. While this is understandable given the enormous uncertainty and delay a complete rewrite would occasion, we hope the FCC will note that the problem it has noted with TELRIC is a fundamental one, that calls for significant countermeasures.

Another problem with TELRIC frequently raised by critics is the tendency of TELRIC to confuse costs and prices. Notably, the Notice does not seem to acknowledge this problem. But it is closely related to the confusion of market process and result and the unreality of TELRIC noted above. Here, a little economic history is useful. Academic economists of the early twentieth century enjoyed themselves developing models of perfect competition, in which all the actors enjoyed perfect information or some such thing, and duly noted that in their models, prices headed downwards to costs. These models were and are helpful in explaining certain trends in real markets. But they were never intended to supply a standard of what real prices "should" be in the real world although they have been misused for that purpose ever since. On the statutory side, it should be noted that not only does the statute direct the FCC to consider costs, but also "a reasonable profit." In real networks, this means that some network elements might in fact be quite far above the cost of an individual element, taking into account the need of the network as a whole to respond to demand and to recover overall costs. If this seems to lead the FCC towards the rejected standard of Ramsey pricing, it should be noted that a few timid, halting steps in this direction would do much to correct TELRIC's tendency to understate costs. Furthermore, it would create opportunities for other access providers to enter the market to undercut ILEC access prices, if those rise far about costs. We strongly urge the FCC to consider correcting the confusion between costs and prices that TELRIC has furthered, as an aspect of looking to real networks.

In the context of the current proceeding, it does appear that a better course would be to look to one or more aspects of the costs of real networks. Almost everyone seems to agree that historic cost is undesirable, at least pre-price caps. In our solutions section, therefore, we focus on the prospects of using aspects of recent cost trends over time, current costs, or current costs plus planned investments.

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[6] *See Notice*, ¶ 50, n. 98, citing Dennis L. Weisman and other critics of the TELRIC.

B. The TELRIC "Black Box:" Negotiations, Arbitration, and Consistency in the States

The FCC's Notice notes the difference in TELRIC rates from state to state and proceeding to proceeding within states.[7] The Commission its concern such inconsistency might not reflect real cost differences, "but instead may be the product of the complexity of the issues, the very general nature of our rules, and uncertainty about how to apply those rules… Part of the difficulty that states and interested parties have encounted springs from the excessively hypothetical nature of the TELRIC inquiry ... [S]tate commissions have wide latitude in applying the "most efficient technology" standard… This creates the potential for a TELRIC proceeding to become a "black box" from which a variety of possible rates may emerge."[8]

As other commentators will no doubt detail at some length, state proceedings that one would think would yield similar results have often, well, not. We will confine our comments here to exploring some aspects of this problem at a "big picture" level.

1. What Have We Forgotten? Or, Why Isn't There An Emerging Wholesale Market?

First, it should be noted that the problem of disparate state TELRIC regimes would be a relatively minor one if more negotiations between ILECs and CLECs, or the arbitrations intended to resolve disputes over those negotiations, were concluded without appeal to the states. Ideally, the FCC's TELRIC rules would be used only in increasingly rare cases where the lease of an ILEC network is not priced at a rate to which both ILEC and CLEC have consented. The Notice's failure to even mention the failure of a real wholesale market in access to emerge in the voluntary sector is a significant oversight. This issue is desperately important to the transition to real markets in telecom. If more negotiations were concluded voluntarily, a real market pricing standard would come to exist that could be used as a standard in cases that did go to the Commissions to resolve. Perhaps, given the present economic environment, it is simply impossible for ILECs and CLECs to reach voluntary agreement; ILECs have something that CLECs need, and small CLECs have little to offer in return. But the evolution of voluntary interconnection in other contexts, for example, in Internet peering, suggests that there are economic conditions under which this is not the case. It might equally well be that negotiations and arbitrations will continue to fail so long as one party feels confident that they can get a better deal in a more political regulatory process. Either way, the problem of why negotiations fail is well worth discussion.

Relatedly, one danger of the FCC's attempt in the present proceedings, to give more guidance to the states in TELRIC proceedings, could in fact *increase* the failure rate of negotiations and arbitrations. One definite merit of the present regime of unbundling is that it does in fact allow (in theory) for the parties to opt out of the rules if only they can reach agreement on a price. But one feature of access pricing deals actually negotiated in real markets (again, looking to Internet peering as an example) is that they seldom look much like the FCC's cost models. While it may be a merit for the states to follow the FCC's lead, one doesn't want businesses engaged in negotiations to feel that they, too, must adopt TELRIC pricing.

So the ideal situation would be to settle on a solution to this problem that gives the states more guidance, but preserves the flexibility of business negotiations and arbitrators. This presents something of a conundrum, which some of the solutions we suggest below may help resolve.

2. Unpacking The Black Box

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[7] *Notice*, ¶ 6.
[8] *Notice*, ¶¶ 6-7.

Some defenders of TELRIC have argued that TELRIC is no more a "black box" than any other regulatory cost accounting. Take historic costs, for example; it would indeed probably be difficult to assess whether a facilities installed in the 1970s was a justified expense. At least, however, someone actually incurred the expense, and its initial amount would be clear, whatever murkiness is introduced later by depreciation methods. Expenses incurred today, now that ILECs are mostly under price caps and face potential facilities-based competition from wireless and even cable, might be entitled to a certain presumption of justification. While parties certainly might endlessly argue about what actually happened or what their immediate plans are, it cannot be *worse* than arguing about what a hypothetical perfectly efficient network would cost.

The Commission asks for comments on how to refine the definition of "efficiency" to give the states more direction. We do not comment on this point, as in the absence of real markets efficiency is impossible to define and the inquiry so abstract as to be of little use in confining the application of TELRIC. It may be possible, however, as we suggest below in "solutions," to give the states more specific guidance on what we can be fairly sure efficiency is *not.*

3. Lack of Accountability in TELRIC Proceedings (Transparency and Verifiability)

The FCC notes that it would be desirable for the cost findings in TELRIC proceedings to have some degree of transparency and verifiability. In particular, the Commission is concerned that focusing more closely on the ILECs' real networks will make it hard for CLECs, state commissioners, or anyone else to check the numbers, as they will be generated within the ILEC system. This raises the general problem of accountability mechanisms, both direct (verifiability and transparency would fall in this category) and indirect.

While there are problems with verifiability and transparency with using real network numbers and plans, it is worth noting that the present TELRIC proceedings tend to suffer from a lack of accountability mechanisms of any kind. Someone once suggested that anyone proposing that an efficient future network could be constructed for *x* cost, and should be priced at *y* rate, should have to build the network for that cost, and sell it for the proposed price. This is probably impracticable, unfortunately.

II. A Range of Solutions & Measures

The ideas below are designed to counterbalance some of TELRIC's worst tendencies rather than to produce a perfect world. Some offer specific substantive guidelines to the states; others suggest how to introduce accountability into different aspects of the TELRIC process.

A. Refocus the TELRIC cost inquiry on real networks.

The FCC's Notice includes proposals to refocus the TELRIC cost inquiry on the actual costs and some of the engineering features of ILEC networks. ocusing the inquiry on current costs has the advantage of the concrete. Facilities-based competition from wireless and price caps have probably reduced ILEC incentives to "gold-plate" enough to entitle costs currently being incurred in the ILEC networks to a strong presumption of efficiency. On the other hand, by the time any individual cost proceeding is over, the cost data might be obsolete. So including some projected cost data from as far ahead as five years would be appropriate.

Interestingly, though, there is no reason that the FCC could not also guide state commissions to consider the costs of networks presently under construction other than ILEC networks. Other networks might include CLEC networks, even wireless networks or cable networks. This would be a useful check on the validity of the ILEC accounting. Also, it is not only the ILEC's costs and prices that shape CLEC incentives; their own costs are also relevant. Everyone has assumed that the statute directs commissions to consider ILEC costs, but the statute does not specifically say so, and TELRIC itself does not consider real ILEC costs.

To further refocus the TELRIC inquiry on real networks, we suggest that the FCC direct the state commissions to recognize that prices in real markets and real networks do not and need not follow costs in any mechanistic sense.

B. Use cost date from other proceedings, including universal service costs data, as a neutrality check.

We strongly encourage the Commission to help depoliticize state TELRIC proceedings and provide some measure of accountability by requiring the states to factor in cost and price data developed outside the TELRIC proceedings. This could include

- price data from any successful ILEC/CLEC negotiations;
- cost data revealed in arbitration proceedings;
- cost data reveal in other commission proceedings or tax proceedings.
- cost data developed in universal service proceedings.
- cost data developed in other states with similar density and geography.

On several occasions, the Commission has briefly stated that it is not appropriate to use cost data from the universal service models in TELRIC proceedings. The Commission's explanation is simply that the universal service models were developed for another purpose. In the Notice the FCC adds an example.

These dismissals of the universal service models as a source of primary data or secondary checks in TELRIC proceedings seem inadequate. If in any respect the universal service models meaningfully measure cost, they are surely of great relevance in TELRIC proceedings. Use of these models would

- reduce delays;
- provide data to counterbalance data that might have been "cooked up" to further one result or another in TELRIC proceedings;
- help check the consistency of different state TELRIC cost measures and prices.

Perhaps the models need some tweaking or adjusting, but it is difficult to see how they cannot be relevant.

The remaining possibility seems to be for the FCC to admit that either or both the universal service and TELRIC models are so biased to serve a certain political purpose (making sure subsidy flows are uninterrupted, in either case) that they do not meaningfully measure economic cost.

C. Try to de-game arbitration proceedings.

As we note above, it is possible that negotiations and arbitration proceedings have a high failure rate for reasons that have nothing to do with the way the regulatory proceedings are structured. Frankly, though, it seems more likely that either or both parties have incentives to delay in the hope of getting a better deal in the "real" proceedings at the state commissions.

The best fix for this would be for Congress to amend the Telecom Act to take away recourse to state commissions altogether. Economist Pablo Spiller has developed more detailed plans for de-gaming pricing disputes by requiring binding fast-track arbitration.

Absent statutory reforms, the FCC should look closely at the arbitration proceedings to see if rules could be devised to reduce gaming. One possibility is to require each party to submit sealed price offers to the arbitrator. The arbitrator will only reveal the offer to the other party if the offers differ by no more than, say, ten or fifteen percent. A second possibility is for the FCC to direct the state commissioners to defer heavily either to the arbitrator's findings, or to his results.

D. Draw up a "Top Ten" list of economic and technological errors in state proceedings.

There are insuperable difficulties inherent in knowing what an "efficient" result is in the absence of a real market (and note that we mean a *real* market, warts and all, not a perfectly competitive market). We suspect, therefore, that FCC attempts to give the state's more positive guidance as to what efficiency is are not likely to succeed in redirecting the states in any meaningful way.

The FCC might, however, give the states more substantive direction by examining the record for methodological and technological errors and misunderstandings in state proceedings. For example, several states have misunderstood fill rates. It is inevitable that communications networks be built with plenty of empty capacity. It would be quite foolish to build them any other way. Some states, however, have assumed in TELRIC proceedings that fill rates ought to be higher; or that ILECs need not be compensated for costs if the (temporarily) unfilled capacity is filled by unbundling competitors instead. This sets up quite the wrong incentives for network construction.

On the pure economics side, states should be directed to avoid naïve measures of success in TELRIC proceedings, such as 1) counting the number of CLECs or 2) counting the number of consumers that CLECs serve. Some attention should be paid to the question of whether the CLECs are moving from resale to their own facilities. Some attention should be paid to the question of whether customers are getting the benefits of network competition, or merely price arbitrage.

Some might ask here why state commissions cannot simply be left to their own devices, to let the forces of federalism work. A partial answer is that in national markets like telecommunications, the forces of competition between states seem to be pathetically weak. Few telecom companies have the option of abandoning the market in any state, and state regulators are more likely to prey upon the mostly out-of-state corporation for local political gain than to fear that its telecom firms will steal away to another state. Furthermore, measuring state against state would be an excellent means of helping TELRIC proceedings along the road to some kind of accountability.

E. Borrow elements from other pricing methods.

The FCC's Notice specifies that the Commission will not consider replacing TELRIC with another pricing regime altogether, such as ECPR or Ramsey Pricing. As a matter of theoretical economics, one could make a strong case that the FCC's choice of TELRIC over demand-based estimates of market prices (both ECPR and Ramsey pricing) is wrong. For example, the FCC rejected ECPR on the grounds that it would base access prices on prices based on monopoly rents; this strangely assumes that regulation of ILEC rates has been entirely useless (a peculiar assume for regulators, anyway) and also dismisses out of hand the possibility that ECPR prices could be adjusted (just as TELRIC prices are) to account for the legacy of monopoly.

Similarly, the FCC criticizes demand-based Ramsey pricing because it would tend to price bottleneck network elements relatively high. But this is precisely what would enable new companies to come in to undercut those prices by offering access alternatives.

Switching pricing methodologies entirely at this phase of the game could give rise to a lot of uncertainty and delay. But it might be possible to incorporate elements of either ECPR or Ramsey pricing as check or balances on TELRIC prices.

F. Measuring success: Some substantive and process markers.

Knowing what an efficient market in telecommunications would look like is, well, difficult. So how is the FCC to know if its reforms to TELRIC produce more accurate pricing signals?

It probably isn't possible to predict how the actual networks will be or should be constructed. It seems at least plausible, for example, that the most efficient result at the present time is for competition for providing two-way voice communications to come from wireless networks almost entirely, perhaps with some build-down into the local exchange from large IXC's or cable. On the other hand, perhaps a thriving wholesale and resale market of interconnected carriers is efficient; the pricing and market structure it might look something like the peering and transit arrangements made for interconnected email networks.

It might be easier to measure success by describing current circumstances that are probably *not* efficient in the sense of providing consumers with real value, and then checking to see if those circumstances alter. Some (not all) non-facilities-based CLEC competition is mere price arbitrage, and so long as it is accompanied by abandonment of real access lines, is probably not providing much of value to consumers.

Other than this, some rough and ready measures of success the Commission should consider include

- A decreased rate of appeal of negotiations to arbitrators, as a real wholesale market in access grows.
- A decreased rate of appeal of arbitrations to state commissions.
- Greater consistency between the TELRIC prices in similarly situated states.
- A slow-down or reversal of the trend towards CLEC abandonment of access lines.
- Somewhat improved assessment of ILEC prospects on Wall Street.
- A general increase in measures of TELRIC costs and also UNE prices, given the powerful arguments that TELRIC consistently tends to understate costs.

Conclusion

These comments offer a variety of "rough and ready" measures to improve the accountability and relevance of TELRIC proceedings. It might be objected that these measures fall short of even theoretically perfect efficiency. Realistically, however, TELRIC's own standard is sadly flawed. We have at best a very gross approximation of markets and at worse a gross distortion of them. To improve the TELRIC process, it is necessary to be honest about the drawbacks of the regulatory process, especially its tendency to become politicized and to produce "gaming." A dose of real networks would be helpful. Another dose of process reforms to reduce politicization of cost proceedings in the states would be very helpful. We hope, however, that the FCC moves with some alacrity along the road to reform.