Before the

SENATE COMMITTEE ON COMMERCE, SCIENCE AND TRANSPORTATION

COMMUNICATIONS SUBCOMMITTEE

Testimony of Ronald J. Binz

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SUMMARY OF THE TESTIMONY OF
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CPI is an independent, non-profit organization that advocates state and federal policies to bring competition to telecommunications and energy markets in ways that benefit consumers.

First, it should be noted that the level of effort expended by the Staff of the Commission, especially the Common Carrier Bureau, to implement the Telecommunications Act of 1996 is nothing short of spectacular. Implementing the Telecommunications Act of 1996 is easily the *biggest* job the agency has ever been given. For consumers, it is also the *most important* assignment the FCC has ever received. While CPI has not always agreed with the decisions reached at the FCC, no one can fault this agency for lack of effort.

Second, the agency has gotten the message that Congress intends that it rely firmly on the forces of competition to produce fair prices and improved services. Conversations with staff at the Commission are suffused with concerns about whether a particular requirement is "too regulatory," or "unnecessary for competition."

In the main, the Common Carrier Bureau and the Commission have faithfully followed through on the vision of Congress expressed in the Telecommunications Act of 1996. Most of the Commission's recent decisions and the Bureau's rulings have advanced competition while retaining appropriate consumer protections. But we also disagree with some of the Commission's decisions and believe consumers could have been better served in some cases.

Local Competition: The FCC's local competition rules were *pro-competitive* because they removed both legal and economic barriers to new entrants entering the local market. The rules were also *deregulatory* because they created a market mechanism designed to reduce the price of exchange access service and move all local exchange rates closer to costs. CPI supports the FCC's role over pricing. The Eighth Circuit's opinion overturning the FCC's pricing policies has the illogical result that the new national competitive framework created by the 1996 Act puts state commissions in charge of interstate services and excludes the FCC entirely.

Universal Service: The FCC has made significant progress toward making universal service funding explicit and sufficient to ensure that telephone rates remain affordable. CPI encourages the FCC to seek agreement of the states to assess universal service contributions on all interstate and intrastate revenues in order to provide a more rational system of universal service. CPI does not support efforts to regulate information providers as telecommunications carriers; instead CPI supports requiring information providers to pay a greater share of the costs of the local telephone "loop". Finally, subsidizing telecommunications services to schools, libraries and health care facilities is a worthy endeavor, although questions can be raised about how much of these telecommunications components should be subsidized by telecommunications

consumers and how much by local taxpayers.

Access Charge Reform: CPI supports most of the structural changes in access charges ordered by the Commission. The decision improved the economic efficiency of the pricing scheme because fixed costs are now collected in fixed charges. We also support the hybrid approach of using a prescriptive reduction in access charges, combined with enhanced efforts to subject exchange access services to competition. However, CPI had advocated a $2 billion initial "down payment" on access reform. Based on the record of the original case, it appears that the $1 billion reduction ordered by the Commission was inadequate. In view of subsequent court rulings that have delayed the growth of competition for access services, there is even more reason to view the original reduction as inadequate.

The BOC Application Process to Enter the Long Distance Market: CPI believes that it is now time for the FCC, the DOJ, the industry and Congress to focus its attention on the public interest standard. In our view, the public interest analysis must ensure that BOC applications to enter the long distance market satisfy the *spirit* of the legislation as well as the *technical details*. CPI submits that the most important factor to consider under the public interest test is whether consumers have a *realistic choice* of alternative providers of local telephone service. If consumers have a realistic choice for local telephone service, consumers are most likely to benefit from the entry of the BOC into long distance.

Pay Telephone Services: The FCC's decision to deregulate pay telephone services was premature and anti-consumer. Local coin rates have already risen to $.35 and are likely to reach $.50 in the short term. Until the payphone market is competitive, CPI believes that the Commission should have allowed states to continue setting maximum prices for payphone charges. The Commission's decision to preempt and deregulate all payphone calls was gratuitous.

Preemption of state and local barriers to competition: To date, the FCC has acted extremely cautiously in exercising its authority to preempt under section 253. The Commission has not yet articulated the relationship between its preemption powers and the states' and municipalities' rights-of-way authority. The unfortunate result is that some states and local governments have imposed a wide variety of regulations and fees on telecommunications providers under the guise of regulating their rights-of-way. This "third tier" of regulation has slowed the growth of local telephone competition and has denied consumers the choices and benefits that local telephone competition can bring.

The Federal Communications Commission has been presented with an assignment that no government in the world has yet successfully completed: transforming a regulated monopoly system of local telecommunications into a competitive marketplace. While the FCC has not avoided all mistakes, the Commission and its Common Carrier Bureau are moving forward to deliver the promise of competition announced by Congress and promised to American consumers.

Testimony of Ronald J. Binz

Good morning, Chairman Burns and members of the Committee. Thank you for the opportunity to testify in these oversight hearings for the Common Carrier Bureau (CCB) of the Federal Communications Commission (FCC). Through these hearings you will address some issues of critical importance to consumers and we appreciate the opportunity to present our views today.

My name is Ronald Binz and I am President of the Competition Policy Institute (CPI). CPI is an independent, non-profit organization that advocates state and federal policies to bring competition to telecommunications and energy markets in ways that benefit consumers. In its two years of existence, CPI has participated before the FCC, state regulatory agencies, the federal courts and the Congress in proceedings to implement the Telecommunications Act of 1996. We have been involved in cases concerning local competition rules, access charge reform, universal service, customer proprietary network information, and many other issues. We have also been involved in several state legislative and regulatory proceedings.

CPI's brings a pro-competitive, pro-consumer approach to telecommunications issues. We believe that competition will bring lower prices, wider consumer choices, greater investment in telecommunications networks, and improved efficiencies among telecommunications providers. CPI balances this trust in competition with the belief that policy makers must ensure that consumers, not simply telecommunications companies, benefit from a more competitive telecommunications environment. Consumers deserve to be protected against fraudulent practices, unauthorized invasions of their privacy, and excessive rates. Most important, consumers deserve a public policy that improves telecommunications by harnessing competition while retaining the best features of a system that consumers understand and trust.

To stay in close contact with consumer interests, CPI is advised by an advisory council of leading consumer advocates from around the country. These consumer representatives (list attached) meet several times a year to provide input and advice on issues of concern to their constituents. Although we rely on these consumer advocates for advice, CPI's policy positions are developed by its senior staff.

CPI receives funding in the form of annual grants from a group of members of the energy and telecommunications industries. A list of CPI's current sponsors is attached and is also available on our web site at <www.cpi.org>. Each sponsor agrees to abide by our charter (attached) and to recognize our independence. CPI develops its policy recommendations based upon input from all segments of the industry, our consumer advisory council, and our own research. CPI is open to receiving funding from any participant in these industries as long as the sponsor respects our independence.

Over the past two years, CPI has participated in dozens of proceedings at the FCC. We have testified before the Commission, filed comments, lobbied commissioners and staff, and filed briefs in support of and in opposition to the FCC. We also work closely with state regulators on many of these same issues so that we are familiar with both sides of the jurisdictional divide. In addition to participating in legal proceedings, I have served on two advisory councils to the FCC: the Network Reliability Council and the North American Numbering Council. This involvement means we are in a strong position to evaluate the efforts of the Common Carrier Bureau and the Commission, both in terms of the process and the quality and impact of its decisions.

Overview

The Committee is correct to monitor closely how implementation of the 1996 Act is proceeding and review the progress the FCC has made in recent years. Implementing the Telecommunications Act of 1996 is easily the *biggest* job the agency has ever been given. For consumers, it is also the *most important* assignment the FCC has ever received.

In the main, the Common Carrier Bureau and the Commission have faithfully followed through on the vision of Congress expressed in the Telecommunications Act of 1996. Most of the Commission's recent decisions and the Bureau's rulings have advanced competition while retaining appropriate consumer protections. But we also disagree with some of the Commission's decisions and believe consumers could have been better served in some cases. Later in this testimony, we offer some recommendations on specific actions the Commission can take to improve the outcome of this implementation for consumers.

Before moving to a review of specific policy items, I would like make two observations that should not be too controversial. The first concerns an issue that has received far too little attention: the level of effort expended by the Staff of the Commission, especially the Common

Carrier Bureau, to implement the Telecommunications Act of 1996.

The level of effort and the volume of results achieved by this agency since passage of the 1996 Act are nothing short of spectacular. The Telecommunications Act of 1996 established some tight time requirements and the Common Carrier Bureau has basically been sprinting since 1996. While CPI has not always agreed with the decisions reached at the FCC, no one can fault this agency for lack of effort, failure to attend to detail, for lack of dedication to a fair process or for spending the taxpayer's funds unwisely. Under the leadership of Regina Keeney, formerly Senior Counsel to this Committee, and now Richard Metzger, the Common Carrier Bureau has produced some truly impressive results. As a former state official and manager in Colorado state government, I know the difficulties of managing such complex processes within a government bureaucracy. The agency deserves high marks for its dedication and tremendous efforts.

Second, I believe that the agency has gotten the message that Congress intends that it rely firmly on the forces of competition to produce fair prices and improved services. Conversations with staff at the Commission are suffused with concerns about whether a particular requirement is "too regulatory," or "unnecessary for competition." Not everyone shares this opinion of the agency's orientation, but as a consumer advocate interested in seeing competition replace regulation, I can say that the Bureau, from its leadership down, understands the twin goals of promoting competition and protecting consumers.

What about the results of these efforts? I will review the performance of the Commission and

Bureau on some significant policy areas related to implementation of the Telecommunications Act of 1996. I have identified some of the successes and shortcomings of the FCC's decisions in these matters. Here are the six areas for review:

- Section 251: the Local Competition Rules
- Section 254: Universal Service
- Access Charge Reform
- Section 271: BOC entry into long distance.
- Section 276: Payphone provisions
- Section 253: Preempting barriers to entry

Implementation of Section 251: the Local Competition Rules

On August 8, 1996, the Commission issued its ***First Report and Order*** implementing section 251 of the Telecommunications Act of 1996. In this rulemaking, the Commission was required to set the basic rules of the road governing the relationship between competing telecommunications carriers for local exchange service. These policies included the requirements for unbundling monopoly telephone networks, interconnecting competing networks and pricing service resale and unbundled network elements. The decision prescribed a cost methodology that should be used to determine the state-specific prices for interconnection and unbundled network elements. In the event that a state could not, or would not, conduct the necessary cost studies to set the proper price, the Commission provided "default" prices for elements. In short, the Commission's order completed "all actions necessary to establish regulations to implement the requirements of this section [251]."[1]

[1] Section 251(d)(1).

This order capped a massive effort. To complete the task, the Commission solicited and received tens of thousands of pages of written comments ranging from the economic theory of efficient pricing to the mechanics of interconnecting phone networks. The Commission sifted through reams of comments on cost models, physical limitations on unbundling telephone plant equipment and proposals for "baseball-style" arbitration.

The result was a decision that staked out a bold new vision of competition for local exchange telephone service. The Commission crafted a set of rules that would provide new entrants with the opportunity to enter the local exchange market in one of three ways: 1) building their own systems and interconnecting to the incumbent (facilities-based); 2) reselling the services of the incumbent provider (resale); or 3) purchasing unbundled network elements (UNEs) from the incumbent provider and fashioning their own services. The rules were *pro-competitive* because they removed both legal and economic barriers to new entrants entering the local market. The rules were also *deregulatory* because they created a market mechanism designed to reduce the price of exchange access service and move all local exchange rates closer to costs.

Here are the most important aspects of the ***Local Competition Order***:

- The Commission found that forward-looking economic costs were the appropriate cost measure to use in setting the price of unbundled network elements;

- Interconnection prices were required to reflect the economic costs of traffic termination on the interconnecting networks;

- The Commission decided provisionally that access charges would not be applied to carriers that used unbundled network elements to complete long distance traffic in conjunction with local service provided to a customer;

- The Commission found that incumbent local exchange companies must provide access to operating support systems (OSS) sufficient to permit new entrants to take service and repair orders from their customers;

- The Commission found that incumbent local exchange companies had to provide a "platform" of network elements to competitors to the extent that those elements were bundled for the incumbent's own use.

The shortcomings or disappointments arising out of the Commission's ***Local Competition Order*** relate not to the elements of the order itself, but to the subsequent history of the order. The decision was appealed to the Eighth Circuit Court of Appeals by several incumbent local exchange carriers, together with several state regulatory commissions and the National Association of Regulatory Utility Commissioners (NARUC). The Court of Appeals vacated the pricing rules of the ***Local Competition Order*** under the theory that the authority to set these prices rested with state regulatory commissions and not the FCC. The court also invalidated the FCC's requirement that incumbent LECs not disassemble previously assembled network elements before providing them to new entrants.

It is unfortunate that the FCC was not able to accommodate the concerns of state commissions sufficiently to avoid an appeal of the Local Competition Order. It is difficult to imagine that the Eighth Circuit would have reversed a decision that was not opposed by state commissions, even if the appeal had been pursued by incumbent LECs that were dissatisfied with the decision. On the other hand, it is also difficult to imagine how the FCC could have acceded to the legal position of some state commissions and still retained its statutory authority to establish the principles under which interconnection prices should be determined.

Interestingly, the majority of states have adopted interconnection rates and prices for unbundled network elements under the same economic theory advanced by the FCC. This is perhaps not surprising for two reasons: 1) the FCC's original proposed Local Competition Rule was based broadly on the experiences of states that had preceded the FCC in the endeavor; and 2) prices between incumbents and new competitors based on economic costs has strong theoretic and practical support. (At least one state that diverged from the FCC's economic theory did so because its methodology yielded *lower* interconnection prices that those calculated by the FCC.)

The Eighth Circuit opinion will be reviewed by the U.S. Supreme Court this fall. CPI has filed a brief in support of the FCC on the pricing and bundling provisions of its original order. In our view, the Eighth Circuit's ruling is inconsistent with the "new model" established by Congress in the Telecommunications Act of 1996.[2] By ruling that unbundled network elements belonged on the state side of the traditional regulatory fence, the Eighth Circuit missed one of the main points that Congress made when it enacted section 251. The newly defined network elements are to be used to provide interstate and intrastate services jointly by new competitors in the local exchange market. In that sense the elements belong to both (or neither) jurisdiction. If the Eighth Circuit opinion stands, it will establish the illogical result that the new national competitive framework created by the Telecommunications Act of 1996 puts state commissions in charge of these critical policies and excludes the FCC entirely. A far more logical construction is to establish that the FCC and the states have shared responsibilities in the process: the FCC establishing the general

[2] Conference Report on S. 652, at 121.

pricing principles; the state commissions implementing those principles with state-specific considerations.

If the Eighth Circuit opinion is reversed, the FCC's original order on interconnection pricing will be reestablished. That will likely mean that a few states will need to modify the competitor-to-competitor prices established since the Eighth Circuit ruling.[3] More important would be the occasion of the Supreme Court restoring the Commission's decision on bundling. The Appeals Court's decision has severely restricted the ability of new entrants to obtain and actually use unbundled network elements. State commissions have had to resort to *ad hoc* methods to attempt to restore the "UNE-platform" option for new entrants.[4]

Implementation of Section 254: Universal Service

There is probably no more complex set of decisions that the FCC must make than to implement the universal service provisions of section 254 of the Act. The statutory language sets forth several general principles for universal service reform, including the requirements that universal service must be explicit and must be sufficient to ensure that rates are affordable. The legislation leaves many of the details of implementation to the FCC and to state regulators. The FCC has

[3]At least one state, Arkansas, has passed a state law requiring the Arkansas Public Service Commission to use "actual" costs to compute the price of network elements. This is widely interpreted to mean "historic" or "embedded" costs, a concept in direct conflict with forward-looking economic costs. It seems likely that this state law would be preempted by the FCC's action following reinstatement of its original decision on pricing.

[4]For instance, the New York Public Service Commission has made "rebundling" a condition of its support for Bell Atlantic's section 271 application.

made a substantial amount of progress to implement these provisions, but much of the work still has yet to be done. The following discussion briefly reviews some of the major decisions made by the FCC to comply with section 254.

- **Federal portion of the universal service subsidy (75/25 split)**

The Telecommunications Act requires the FCC to establish a federal program to fund a portion of the costs of preserving and expanding universal service. The FCC initially decided that the federal fund would cover only 25% of the amount necessary to ensure that telephone rates be just, reasonable and affordable. The 25% division of responsibility is consistent with the historic practice of the FCC and the states to allocate 25% of the costs of the local telephone "loop" plant to the federal jurisdiction, while the remaining 75% was funded by the states. The FCC adopted this 25% division once it became clear that many states would not support assessing universal support on combined intrastate and interstate revenues. In other words, the FCC decided that if it accepted the states' request to assess universal service contributions only on carriers' interstate revenues, it would only be able to fund the "interstate" portion of universal service.

CPI supports the use of combined interstate and intrastate revenues of telecommunications carriers as the correct basis to compute both federal and state universal service funds. We understand the reluctance of the FCC to push to include more responsibility in the federal fund if states are unwilling to use the combined revenues approach.

In recent communications, the FCC has said it intends to revisit the 25% division of funding responsibility in order to ensure that states continue to receive as much federal funding as they formerly received. Revisiting this 75/25 split is appropriate in order to ensure that no state is required to raise rates to subsidize universal service. CPI encourages the FCC to continue to seek agreement of the states to assess universal service contributions on all interstate and intrastate revenues in order to provide a more rational system of universal service.[5]

- **Distinction between telecommunications carriers and information services providers**

The Telecommunications Act adopted specific definitions of telecommunications service, telecommunications carrier, and information service. These definitions are almost identical to distinctions between "basic telecommunications" and "enhanced services" that the FCC adopted in its Computer II and III inquiries. These definitions are essential to ensure that the FCC's regulations of common carriers do not inadvertently apply to information services that do not need to be regulated. Some observers are understandably concerned about the effect on universal service if information services providers are allowed to transmit telephone calls and carry other traffic that may be indistinguishable from common carrier traffic without contributing to universal service support. However, redefining information services as telecommunications carriers would significantly expand the scope of federal and state regulation to an industry that is relatively competitive and for which there is no need to regulate. To the extent that the use of information services could affect universal service, the Commission should instead consider requiring

[5] Reciprocity should apply to the collection of these funds. If the FCC is permitted to assess universal contributions on interstate and intrastate service, states should also be permitted to assess their contributions on interstate and intrastate services of carriers operating in their states.

information services providers to bear a greater share of the costs of the local loop. Currently, long distance providers must contribute to the costs of the local loop; information service providers make use of the consumer's loop in much the same way as long distance companies and should pay their share of these costs.

- **Low-income programs**

To comply with the universal service provisions of the 1996 Act, the FCC expanded the scope of its Lifeline and Link-up programs. These programs ensure that low-income consumers can continue to receive "affordable" telephone service. By subsidizing individual subscribers directly, these programs are among the most efficient subsidy programs because they target those customers who are most in need of subsidy support.

- **Interaction of universal service subsidies and interstate access charges**

The FCC decided that carriers that receive funds from the universal service fund should reduce their interstate access charges by the amount of the universal service funds they received. As the FCC recently explained in its Report to Congress, this decision does not mean that universal service funds are being used to reduce access charges instead of reducing telephone rates. Rather, the FCC's decision reflects an effort to comply with the statutory mandate that universal service subsidies must be explicit and must be collected from all telecommunications carriers. Currently, universal service is subsidized by access charges paid by long distance companies. The FCC decided to comply with this statutory mandate by requiring all carriers to contribute a percentage of their revenues to support universal service to a federal universal service fund. Once this federal fund comes into being, there will be no need for the telephone companies to continue collecting universal service subsidies with inflated access charges. Therefore, in order to keep the telephone companies from recovering twice the amount needed to keep telephone rates low, the FCC correctly ordered telephone companies to reduce their access charges by the amount received from the universal service fund.

- **Subsidy program for schools, libraries and rural health care**

Based upon the recommendation of the Federal-State Joint Board, the FCC has decided to establish a fund of up to $2.65 billion per year to subsidize telecommunications services to schools, libraries and health care facilities. This fund is separate from and will not directly affect the funds available to support universal service in high cost areas. However, funds required by this program will be collected by telecommunications carriers from their customers.

The effort to improve telecommunications capability to students and rural healthcare providers is certainly worthy. Some have criticized these subsidy programs as a "tax" on telecommunications carriers and consumers. On the other hand, telecommunications carriers and consumers will benefit in many ways from the increased use of telecommunications services by schools, libraries and health care facilities. Substituting telecommunications costs for travel costs or for inferior care will also cost less from a societal perspective. These arguments are advanced to support telecommunications consumers and carriers to help to fund improved telecommunications access to schools, libraries and health care institutions.

Other questions have been raised about the use of these funds to subsidize internal computer connections, pagers and inside wire. At some point, it becomes legitimate to question how much of these telecommunications components should be subsidized by telecommunications carriers (and consumers) and how much should be subsidized by the local taxpayers who use the services. The FCC should implement this program in a way that ensures the local community shares the responsibility of bringing these advanced technologies to their schools, libraries and health care institutions.

Implementation of Access Charge Reform

One of the largest single collections of costs in the telecommunications industry are lumped under the heading of "access" costs, most of which are paid by long distance companies to local telephone companies. In 1996, access charges totaled more than $30 billion and included many different sorts of costs. Besides the direct costs of actually completing long distance calls, access charges contained universal service subsidies, historic costs in excess of economic costs, earnings in excess of the target rate of return authorized by the FCC, accounting adjustments (regulatory assets) being amortized over time, and other charges.

In 1997, the FCC set about the task of reducing and restructuring access charges. While the Telecommunications Act of 1996 did not specifically require the FCC to review and restructure access charges, the very close connection between access charges, local competition rules and universal service support meant that the FCC could not make changes in one area without considering the effects elsewhere. It had also become clear that access prices far in excess of costs were in fundamental conflict with a competitive telecommunications environment. Finally, access charge reform would also entail a review of the FCC's price cap regulatory scheme, since access prices were driven by the operation of the price cap system.

There were at least three concerns with the previous system of access charges:

- Access rates were too high in absolute terms;
- The access charge rate structure was economically inefficient;
- Access charges applied only to long distance carriers, not to other network users

Following an extensive round of comments, reply comments and *ex parte* presentations, the Commission issued its ***Access Reform Order*** concurrently with its ***Universal Service Order*** and its ***Price Cap Order***.

The Commission faced a fundamental decision about how to lower the absolute level of access charges: whether to employ a "prescriptive" approach or whether to rely on market forces to force access charges nearer to costs. Some of the costs were scheduled to be "transferred out" of the access cost bucket and reclassified as universal service support. However, the remaining access charges would still be, by most admissions, far in excess of costs. The Commission decided, correctly in our view, to use a hybrid approach. After an initial "prescriptive" reduction, the Commission expressed its faith that competition for exchange access services would put downward pressure on access charges. In its order, the Commission required initial access reductions of $1.7 billion, of which approximately $700 million was already scheduled to occur due to the operation of price caps. Thus, the actual (net) reduction was about $1 billion.

The Commission also reasoned that, since access charges represented costs that did not vary with usage, the recovery of those costs should occur on a flat-rate basis, and not as part of a per-minute charge. In its decision, the Commission instituted a new charge, the Primary Interexchange Carrier Charge (PICC) designed to recoup from interexchange carriers some of the access costs previously collected in per-minute charges. This change had the effect of reducing the per-minute costs of access and long distance charges. The decision is also pro-competitive because the PICC will be paid by long distance companies to the telephone company only when the telephone company serves the customer. If the telephone company loses a customer to competitor, the telephone company will not collect the PICC.

CPI supports most of the structural changes in access charges ordered by the Commission. The decision improved the economic efficiency of the pricing scheme because fixed costs are now collected in fixed charges.[6] We also support the hybrid approach of using a prescriptive reduction in access charges, combined with enhanced efforts to subject exchange access services to competition. However, CPI had advocated a $2 billion initial "down payment" on access reform. Based on the record of the original case, it appears that the $1 billion reduction ordered by the Commission was inadequate. In view of subsequent events, there is even more reason to view the original reduction as inadequate.

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[6]Interexchange carriers (who pay PICCs to the local exchange companies on behalf of the IXCs' customers) are not required to pass the PICCs through to their own customers in any particular fashion. Since interexchange service is competitive and has been detariffed by the FCC, the decision whether to pass through the PICC on a flat-rate basis, as well as the decision whether to include the item as a separate line on the customer's bill, is up to the interexchange carrier to determine.

Since the FCC's ***Access Reform Order*** two things have happened, and one thing has not happened. First, the Eighth Circuit Court of Appeals, in its review of the Commission's ***Local Competition Order***, invalidated the FCC's rule that prohibited the incumbent local carriers from disassembling previously assembled combinations of network elements (e.g., lines and ports). Second, the telephone companies continue to achieve very high earnings under the current price cap regime, far in excess of the benchmark rate of return authorized by the Commission. These returns persist even after the $1 billion access charge reduction ordered in 1997 and even after the Commission adjusted the productivity factor in its price cap plan. Most important, though, is something that has not happened: competition from UNE-based entrants has not materialized to any substantial degree. This means that the Commission's original assumption — that pressure from UNE-based competitors would force access toward costs — is proving to be unreliable, at least over the next few years.

The combination of these three considerations suggests that the Commission should revisit the assumptions underlying the Access Reform Order. We do not suggest that the Commission abandon its hybrid approach to access charge reductions. Instead, the Commission should consider additional prescriptive reductions and review its options for spurring additional competition for exchange access services. The FCC has a pending petition filed by the Consumer Federation of America, the International Communication Association and the National Retail Council asking the Commission to reduce access charges to costs immediately. In response to this petition, CPI suggests that the Commission examine the slow pace of local competition and consider additional "prescriptive" reductions in access charges. These additional reductions would serve consumers directly in the form of lower long distance rates and would also take some of the pressure off rates created by access restructuring and the funding requirements for universal service programs.

Implementation of Section 271: BOC entry into long distance.

Of all the provisions of the Telecommunications Act of 1996, the area where the FCC has been most closely scrutinized is its interpretation of section 271, concerning BOC entry into long distance services. Section 271 states that the FCC may not approve a BOC application to enter the long distance market unless it finds that 1) the BOC has "fully implemented" or made available all the items on the 14-point competitive checklist; 2) the BOC will comply with the separate affiliate requirements of section 272; and 3) the application is consistent with the public interest convenience and necessity. Since passage of the Act, the FCC has reviewed and denied four petitions for long distance entry: for Michigan, Oklahoma, South Carolina and Louisiana. In our view, the Commission acted correctly in each case: none of the applicants had qualified under section 271 of the Act.[7] The FCC should continue to interpret section 271 carefully because of its critical importance as an incentive for the BOCs to open their networks to competition.

To date, most of the discussion concerning section 271 has focused on the complexities of Track A and Track B and the details of the 14-point competitive checklist. In rejecting each of the four BOC applications, the FCC found that the BOC had not satisfied some of the checklist items.

[7]In hindsight, the main purpose of the Oklahoma section 271 application at the FCC appears to have been to provide a *precis* for an appeal to the Federal District Court in Wichita Falls challenging the constitutionality of section 271.

The Department of Justice has engaged in extensive evaluations of each application to determine whether the BOC has truly opened its network to competitors and whether the BOC has instituted performance benchmarks in order to measure the openness of the network. Recently, the FCC responded to the letter of Senators McCain and Brownback by providing a detailed description of the checklist requirements. In short, the FCC, the DOJ, and the industry have together made great strides toward filling in the details of the checklist requirements.

CPI believes that it is now time for the FCC, the DOJ, the industry and Congress to focus its attention on the public interest standard. Although the Commission has ruled on four section 271 applications, the FCC has not yet adopted a definitive interpretation of this important standard. The FCC's decision in the Ameritech-Michigan application asked a number of worthwhile questions and discussed a range of options for interpreting the public interest approach. But the FCC stopped short of settling on any single approach. The FCC's failure to issue a definitive interpretation of the public interest standard constitutes another uncertainty that could delay progress toward achieving the benefits of the Telecommunications Act. In short, now that the FCC is close to resolving issues concerning checklist implementation, it should turn its attention to the public interest standard.

In our view, the public interest analysis must ensure that BOC applications to enter the long distance market satisfy the *spirit* of the legislation as well as the *technical details*. Said another way, the public interest test should allow policymakers to use common sense to determine whether consumers will be better off if the application is approved or denied. After all, the essential promise of the Telecommunications Act of 1996 is that consumers will have competitive choices for local service and long distance service, not merely that five companies have met a set of fourteen technical requirements.

The public interest test allows policymakers to consider <u>all</u> the factors that determine whether consumers would benefit from BOC entry into the interLATA market. As examples, these factors should include: whether the BOC's interLATA entry would lead to reduced prices for long distance service; whether the BOC's entry would increase its ability and incentives to discriminate against long distance companies because of its ownership of local exchange facilities; whether the BOC has engaged in any illegal or discriminatory behavior; the extent and level of local telephone competition in the State; whether the BOC's entry would permit consumers to use one-stop-shopping for all their telecommunications services; and whether actions by local governments, state legislatures, or regulatory commissions are impeding entry by competitors for local telephone service.

CPI submits that, while all these factors are important, a single, overarching factor to consider is whether consumers have a *realistic choice* of alternative providers of local telephone service. If consumers have a realistic choice for local telephone service, many of the other issues that bear on the merits of BOC entry will naturally follow. For instance, if consumers have a realistic choice for local telephone service, the BOC will have much less incentive and ability to discriminate against long distance companies because these companies will have an alternative means of reaching their customers. If consumers have a realistic choice for local telephone service, that means the BOC is not discriminating against the local service competitor for access and interconnection to the BOC's network. If consumers have a realistic choice for local telephone service, interLATA entry by the BOC is more likely to produce consumer benefits because the BOC will have greater incentives to pass on savings it achieves to consumers in the form of lower rates. Finally, if consumers have a realistic choice for local telephone service, that will provide the best evidence that the market for local telephone service is truly open to competitive entry and that checklist compliance is real and is, in fact, working.

Payphone provisions

The Telecommunications Act of 1996 contained a provision, section 276, designed to promote competition among payphone service providers and to promote the widespread deployment of payphone services to the public. In furtherance of these goals, Congress required the Commission to adopt new regulations that, among other things, would "establish a per call compensation plan to ensure that all payphone owners are fairly compensated for each and every completed intrastate and interstate call using their payphone..."[8] The new statutory section also discontinued the access charge system previously in effect and required the Commission to adopt non-structural safeguards applied to Bell Operating Companies to ensure that competition among payphone providers was fair.

In response to this mandate from Congress, the Commission went much further than the

[8] Section 271(b)(1)(A).

requirements of this section. In addition to adopting a compensation rate for all calls made from payphones, the Commission preempted state regulation of all payphone rates and charges. The decision was a classic case of bootstrapping: the Commission reasoned that compensation rates would best be determined in a competitive marketplace. In other words, payphone providers should receive compensation at a market rate. In order to fashion a market rate, the Commission reasoned that all payphone rates would have to be deregulated. To achieve that, the Commission used its authority in section 276 to preempt state regulation of all payphone rates.

As a direct result of the Commission's order, prices on most payphones have risen from the common maximum rate of 25 cents per call to a new level of 35 cents per call. CPI fully expect that rate to go to 50 cents or higher in short order.

CPI agrees with the Commission that rates for payphone compensation should eventually be set by the results of a competitive market. Competition will ensure that the "correct" number of payphones are deployed and that prices for their services will be driven to cost. **The difficulty is that the payphone market is not now competitive**. While there is competition among payphone service providers (PSPs) for *locations,* payphones are not competing head-to-head to produce the lowest price for consumers. In fact, many PSPs have locational market power and bid against each other to provide the highest possible commissions for the location owners, driving up consumer prices.

It's an old regulatory saw that "deregulation" is not the same as "competition." Until the payphone market is competitive, CPI believes that the Commission should have allowed states to continue setting maximum prices for payphone charges and was on solid legal and economic grounds to set payphone compensation based on the costs incurred by the PSPs in providing access services. The Commission's decision to preempt and deregulate all payphone calls was gratuitous.

The Act merely required the Commission to establish a plan that produces payphone compensation at a level that "fairly" compensates payphone service providers for their services. A compensation rate that provides the PSPs with cost recovery (including a fair profit) would produce rates that are "just and reasonable" and which would have passed muster as being "fair." In many cases decided by the Commission, parties often remind the FCC that "competition will drive prices toward costs." It is a tenet of economics that competitive prices are based on cost — there is nothing old-fashioned or retrograde about this concept. Under this economic principle, payphone service providers should recover their costs and only their costs. After all, a competitive market does not countenance a provider that charges prices higher than costs. If that is attempted, a new competitor will enter the market by cutting prices and take the customers.

Section 253: Preempting barriers to entry

Section 253 of the Act requires the FCC to preempt state and local government regulations that may "prohibit" or "have the effect of prohibiting" the provision of telecommunications services. But the statute protects state and local government action that is necessary to protect universal service or that is a reasonable effort to regulate state or municipal rights-of-way.

To date, the FCC has acted extremely cautiously in exercising this preemption authority. In general, the Commission has preempted only those state and local actions that explicitly "prohibit" competitive service; the Commission has refrained from taking action against provisions that "have the effect of prohibiting service." Furthermore, the Commission has not yet articulated the relationship between its preemption powers and the states' and municipalities' rights-of-way authority.[9] The unfortunate result is that some states and local governments have imposed a wide variety of regulations and fees on telecommunications providers under the guise of regulating their rights-of-way. This "third tier" of regulation has slowed the growth of local telephone competition and has denied consumers the choices and benefits that local telephone competition can bring.

For instance, the city of Troy, Michigan requires all new entrants to obtain franchises from the city, requires them to submit to the city's interconnection obligations, and imposes a number of other burdensome requirements. The city also barred TCI, the incumbent cable company, from deploying fiber optic facilities. TCI filed a request for the FCC to preempt the Troy Ordinance. In the comments on the TCI petition, MCI claimed that the regulatory nature of Troy's ordinance caused MCI not to provide service in Troy. Nevertheless, the FCC declined to rule either for or against TCI's request for preemption under section 253. The FCC found instead that the city's action was a violation of the Cable Act, but it took no action on the preemption claim under

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[9] The FCC has been so cautious in exercising this authority that parties have been discouraged even from asking the FCC to act. Instead carriers and consumer organizations are filing suit in court, hoping that the courts will provide stronger enforcement of the law prohibiting barriers to entry.

section 253.[10] The FCC included in its decision a number of statements designed to "provide guidance" to municipalities against excessive regulation.

The FCC's September 1997 decision does not appear to have had much success in controlling the cities' appetite for greater regulation. Cities around the country have taken the following actions:

* Some cities require companies laying lines using rights of way to pay <u>three</u> separate fees: an application fee (to recover the costs of processing the application), a "trench cut" fee (to recover the city's costs of digging and repairing the street, and other construction and maintenance work); AND an annual franchise fee (to recover the "rental value" of the right-of-way).

- Some cities impose fees based on all the revenues of a provider, including interstate revenues over which the municipality has no jurisdiction.
* Some cities have imposed fees solely upon new entrants in the market for local telephone services but explicitly exempt the incumbent provider from paying the same fees. In other cases, new entrants must pay a significant franchise fee, but the incumbent telephone company is "grandfathered" by decades-old franchises that do not require it to pay any franchise fee.
- Some cities have imposed franchise fees on resellers who do not construct any new

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[10] According to an FCC staff member, the Troy decision "did not address the important issue raised by the parties as to whether a franchised cable operator can be required by a city to obtain a second franchise before providing telecommunications services in that locality," despite the existence of a fully developed record regarding TCI's section 253 claims. See Presentation of Barbara S. Esbin, Associate Bureau Chief, Cable Services Bureau, FCC, before the National Conference of State Legislatures, April 17, 1998.

facilities, but who simply provide service using the facilities already in the ground. These resellers impose no costs upon the city. Further, the city already collects fees from the revenues earned by the owner of the underlying facilities, so the city is able to "double recover."[11]

In short, many municipalities have used the rights-of-way authority preserved by the Telecommunications Act to exercise broad regulatory authority over all telecommunications carriers. The FCC's failure to clarify the interaction between barriers to entry and legitimate rights-of-way regulations, and the FCC's unwillingness to preempt actions that "have the effect of prohibiting" entry, have contributed to the slow pace of telephone competition.

Conclusion

The Federal Communications Commission has been presented with an assignment that no government in the world has yet successfully completed: transforming a regulated monopoly system of local telecommunications into a competitive marketplace. The technical and economic complexities of the task are daunting enough. Add the fact that the current system was shot through with subsidies and is fractured into multiple federal, state and local jurisdictions. Stir in a judiciary that must view the world through case law that lags the telecommunications revolution by many decades. Ask the FCC to undertake this assignment in a charged competitive and political atmosphere. Finally, require the agency to use litigation as its main technique for arriving

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[11] By contrast, the State of Nevada recently passed legislation prohibiting cities and counties from requiring telecommunications service providers to obtain a franchise (or pay franchise fees) "if it provides telecommunications service over the telephone or telegraph lines owned by another company." Nevada Assembly Bill No. 508, Approved July 16, 1997, Sec. 16.2.

at decisions.

Despite these handicaps, we perceive some progress in moving to a fully competitive telecommunications future. Congress did its part by passing the Telecommunications Act of 1996. While the FCC has not avoided all mistakes, the Commission and its Common Carrier Bureau are moving forward to deliver the promise of competition announced by Congress and promised to American consumers.

CPI appreciates the opportunity to present its views on the performance of the FCC's Common Carrier Bureau in achieving that goal.