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Fresh Thinking on Special Access

by

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In January, the National Regulatory Research Institute released a report entitled, *"Competitive Issues in Special Access Markets."*[1] While some of the NRRI Report recommendations relate to improving data collection capabilities as an aid in determining the extent to which competition exists, the authors more substantively suggest that the Federal Communications Commission should open a new proceeding "to reset the special access rates of AT&T, Qwest, and Verizon."[2]

Rather than supporting the conclusion that a new rate-setting proceeding is needed, the NRRI Report does nothing if not reinforce the conviction that it is time for fresh thinking on the seemingly never-ending question of whether special access services should be re-regulated.[3] With a new FCC Chairman and a new Commissioner and new Administration policymakers coming on board shortly, fresh thinking would be especially timely and valuable.

As explained below, the NRRI recommendation to begin a new special access rate case reveals much about the authors' hard-wired regulatory mindset and their failure to appreciate the extent to which the telecommunications marketplace already has changed and is continuing to change. Before explaining in this short paper why, in a macroeconomic sense, such a pro-regulatory mindset is not appropriate in today's dynamic telecommunications market, I want to comment briefly on an obvious deficiency with the NRRI paper.

Data Limitations Render Report's Conclusions Suspect

Throughout the report, the authors acknowledge that data limitations impacted their ability to reach conclusions (which in important instances they nevertheless proceeded to reach). For example, the authors sum up: "Many carriers ultimately did not provide data."[4] Not surprisingly, "[t]he limited data submissions constrained our analysis in some ways."[5] More specifically, they say "[p]ricing data were too incomplete to support a comprehensive analysis of long-term pricing trends between 2001 and 2006."[6] And immediately following is this: "Absence of seller data from competitive fiber providers, from broadband wireless providers, and from cable TV providers limited our ability to verify market concentrations and to verify buyer reports on the prices charged by non-ILEC sellers."[7] And AT&T and Qwest refused to provide data when it became apparent that many non-ILEC competitors were not doing so.

The acknowledgment by the report's authors of the severe data limitations is, in one sense, admirable. But their willingness to plow ahead and reach conclusions in the face of limited data is not. And this is especially so because their approach, bound up as it is in the mode of traditional rate case thinking permeated by static market analysis, is necessarily market data dependent. Even when data exists which tends to support the conclusion that the special access market is becoming more competitive, the authors seemingly go out of their way to discount such data. For example, the report finds that "ILEC market shares declined from 2006 to 2007, primarily in the DS-3 markets."[8] And the report contains evidence of substantial discounting of ILEC special access rates for customers willing to subscribe to discount plans. But the tendency is to explain away such data in a seeming effort to relegate such competitors to what they call "acting on the fringes"[9] of the special access markets.

Thus, there are significant flaws in the report's approach, taken on its own terms. Reading the report I have the impression that the special access market already is more competitive than, for whatever reason, the authors are willing to credit. But now I want to move beyond the mostly micro-analysis the authors attempt to employ, handicapped as it is by the data limitations, and comment on what I see as a more fundamental flaw in continuing the special access debate on the NRRI Report's own terms.

The Report's Pro-Regulatory Static Market Approach Is Wrong

A good departure point for explaining the report's fundamental flaw is this significant statement in NARUC's press release accompanying the report: "According to the report, there is no evidence to support any bright-line judgment on special access market power."[10] As shown above, especially in light of the acknowledged data limitations, this is a fair characterization of the report. Nevertheless, despite the lack of evidence, the report somehow concludes that the

FCC should initiate a new rate proceeding. The lack of evidence to make bright-line judgments concerning ILEC market power should point policymakers towards a deregulatory rather than re-regulatory approach. In other words, in today's dynamic communications marketplace environment, the absence of convincing evidence of the existence of market power should mean that rate regulation of special access should not be imposed.

Here are some important foundational principles relevant to explaining why, in the absence of convincing evidence, rate regulation is inappropriate.[11]

1. Policymakers should not rely exclusively, or even predominantly, upon market share to draw inferences about market power in telecommunications markets. As Judge Richard Posner, a leading law and economics scholar has explained: "Competition is not a matter of many sellers or low prices or frequent changes in prices or market shares. It is properly regarded as a state in which resources are deployed with maximum efficiency, and it is not so much the existence of actual rivalry, let alone any specific market structure or behavior, as the potential for rivalry, that assures competition."[12]

As pointed out above, the NRRI Report places too much emphasis on present market share, thus, inappropriately diminishing, for example, the notion of "contestability" that gives more credence to the impact of potential competition. For example, the report readily acknowledges that cable and wireless technologies "can provide acceptable substitutes for special access channel terminations, and their providers can have lower entry and exit costs."[13] Nevertheless, with the fixation on trying to determine market share -- despite the lack of reliable data – this finding has little impact on the authors' ultimate conclusions. The authors report that "[f]requent bidding by large customers, with multiple bid responses, is a positive indicator of increased competition, at least within the market sectors devoted to enterprise and wholesale customers."[14] But, similarly, this finding seems not to have held much sway with the authors.

2. Deregulation policies should strike the proper balance between allocative, technical, and dynamic efficiency. In effect, this means, for example, that there are often trade-offs between short-term gains for competitors, say, in the form of lower prices for regulated inputs and longer-term societal gains that result from the increased innovation and investment attributable to the opportunity for the incumbent to earn higher returns.

The NRRI report has little to say about the impact of price regulation on incumbents' investment decisions. With the spotlight predominantly on *current* market shares, and non-ILEC *competitors'* views of near-term market prospects, the report's focus is decidedly on the short-term rather than on long-term societal gains. In this context, the effect of price constraints on longer-term investment and innovation is largely ignored.

3. High price-cost margins, reflective of the scale and scope economies found in the telecommunications industry, often serve to constrain the incumbent's market power after deregulation. When a firm operates with high price-cost margins, only a relatively small number of marginal customers willing to discontinue service or switch to an alternative provider are able to defeat a price increase. These marginal customers discipline the pricing behavior of the incumbent. This is what we mean when we say, "competition occurs at the margin."

The applicability of this point to the special access situation should be obvious. As pointed out above, while determining the *precise* extent of competition always may be problematical, the NRRI Report authors acknowledge new entrants using new lower-cost technologies are attracting some special access customers. Even assuming the ILECs do indeed enjoy high-price cost margins, it doesn't take much new entrant "competition at the margin" to act as a constraint on ILEC prices.

4. In an ideal world, regulators should deregulate at an "appropriate" time based on an objective assessment of market conditions. That is to say that, ideally, the decision to deregulate should occur no earlier and no later than when the incumbent's market power is reduced to a level such that the incumbent can no longer extract "monopoly" rents. In the real world, however, it is almost impossible for regulators to act with such exquisite timing. Given a choice between "too early" or "too late," it is generally preferable for regulators to err on the side of too early.

Another way of making this point is to say that there is a natural bureaucratic tendency for regulators not to want to "let go" of regulatory activities. But in situations when there is evidence that competition is taking hold and new entrants are offering substitutable services, the error costs of deregulating "too late" are likely to outweigh those associated with deregulating too soon. This is because, in a communications marketplace environment characterized by Schumpeterian dynamism and rapid technological change, the lost opportunity costs associated with diminished investment and from stifled innovation are likely to exceed the benefits of any additional measure of consumer protection realized from rate regulation.

Conclusion

There is a definite need for fresh thinking regarding the regulatory treatment of special access services because, even as more evidence accumulates that non-ILEC alternatives increasingly are available and are constraining the ILECs' prices, there continue to be calls for rate re-regulation, or for a halt to further deregulation of special access services. The NRRI Report is disappointing in that it is of a piece with these past pro-rate regulation calls that adhere to a static market view, even though the authors acknowledge positive competitive developments are occurring and readily concede that data is lacking to make a "bright-line" determination that the ILECs continue to possess market power. In these circumstances, the best that one can hope for from the NRRI Report is that, by virtue of this and other reactions, it might be a spur for the fresh thinking that is needed on this subject.

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[1] Peter Blume (with Dr. Robert Loube), "Competitive Issues in Special Access Markets," National Regulatory Research Institute, 09-02, January 21, 2009 (hereinafter the "NRRI Report"). While corporately independent, NRRI is affiliated with the National Association of Regulatory Utility Commissioners in certain ways. For example, NRRI receives funding from the state commissions and state public utility commission members constitute a majority of the members of the Board of Directors of NRRI.

[2] NRRI Report, at V.

[3] Most (but not all) special access circuits are at DS-1 (1.5 mbps) level or higher. And, as the reports states, "[t]oday, most special access circuits convey data in digital format." NRRI Report, at 3. In other words, although rarely directly acknowledged, most special access services are broadband facilities. Since 2002, the FCC has had in place a general policy to the effect that broadband services should exist in a "minimally regulated environment." Appropriate Framework for Broadband Access to the Internet over Wireline Facilities, 17 FCC Rcd. 3019, 3022 (2002). It is a bit curious that it is assumed that by continuing to refer to these generally high-capacity circuits as "special access" they are somehow unaffected by the principle that broadband circuits should exist in a minimally regulated environment.

[4] NRRI Report, at 37.

[5] Id.

[6] Id.

[7] Id., at 38.

[8] Id., at 46.

[9] Id., at iv.

[10] "Final Report on Special Access Released," NARUC Press Release, January 23, 2009.

[11] The principles are taken, with some minor modifications, from my earlier paper, "Special Access and Sound Regulatory Principles: The Market-Oriented Case Against Going Backwards," Perspectives of FSF Scholars, Vol. 2, No. 16, June 24, 2007. The paper may be found here: http://www.freestatefoundation.org/images/Special_Access_and_Regulatory_Principles.pdf. In turn, my June 2007 paper owes much to Dennis L. Weisman, *Principles of Regulation and Competition Policy for the Telecommunications Industry--A Guide for Policymakers*, The Center for Applied Economics, Kansas University School of Business, Technical Report 06-0525, May 2006, cited therein.

[12] Richard A. Posner, "The Effects of Deregulation on Competition," *Fordham International Law Journal*, Volume 23, 2000, p. 18.

[13] NRRI Report, at 56.

[14] Id., at iii.