**Before the**
**Federal Communications Commission**
**Washington, DC 20554**

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

# Comments of The Progress & Freedom Foundation

Raymond L. Gifford
President

The Progress & Freedom Foundation
1401 H Street, NW
Suite 1075
Washington, DC 20005
(202) 289-8928
(202) 289-6079 Facsimile

December 16, 2003

The Progress & Freedom Foundation (PFF), a private, non-profit, non-partisan research institution, submits these comments pursuant to the Notice of Proposed Rulemaking (NPRM) in this proceeding. The views expressed in these comments are those of the author and do not necessarily reflect the views of the directors, officers or staff of the Foundation.

## I. Introduction

Along with unbundling, Total Element Long Run Incremental Cost (TELRIC) is *the* problem with implementation of the Telecommunications Act of 1996 (Act). The TELRIC standard introduces an unacceptable level of analytic indeterminacy into the process of implementing the Act. This indeterminacy then allows illegitimate secondary considerations, such as the creation of margin between wholesale and retail rates, to predominate in actual, "real world" TELRIC rate-setting. Further, TELRIC's plasticity leads to wide variability in rates that cannot be squared with the Commission's stated desire for a pricing methodology "conducive to efficient facilities investment."[1]

The Commission, therefore, should appropriately alter the wholesale pricing methodology to better-define a rule that is: a) forward-looking; b) definite; and c) capable of consistent and principled implementation. This rule would defer to the necessity for continued prescriptive regulatory ratemaking on an interim basis, while also recognizing the institutional impossibility of setting rates based on a speculative, hypothetical standard.

[1] *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, Notice of Proposed Rulemaking, FCC 03-224, at ¶ 3 (Rel. Sept. 15, 2003).

I confine my comments to the narrow issues of performing a TELRIC analysis *in practice*. In that vein, these comments are aimed at paragraphs 3, 4, 7, 52 and 60 of the NPRM. Those paragraphs ask generally how TELRIC can be changed to reflect more real world considerations, and whether such changes would make for a more principled, predictable and competition-beneficial rate-setting method.

I will leave it to other parties to discuss the forward-looking incentive effects of current TELRIC ratemaking and the competition policy effects of TELRIC.[2] I wish only to discuss the practical impossibility of applying the prescribed methodology and offer some suggestions on how this could be changed.

## II. Background

I sat as hearing commissioner as Chairman of the Colorado Public Utilities Commission in Docket 99A-517T, *In the Matter of U S West Communications Inc.'s Statement of Generally Available Terms and Conditions*. This docket resulted in a Commission Order, Decision No. C01-1302, and an Order on Rehearing, Reargument or Reconsideration, Decision No. C02-409 (the Colorado TELRIC proceeding). The rates from this docket served as benchmark rates for the Qwest region in the nine state § 271 application.[3]

[2] *See, e.g.,* Justice Stephen Breyer, "Economic Reasoning and Judicial Review," AEI-Brookings Joint Center 2003 Distinguished Lecture (Dec. 4, 2003), *available at* http://www.aei.org/news/newsID.19559/news_detail.asp; *Verizon Communications Inc. v. F.C.C.*, 535 U.S. 467, 539 (2002) (Breyer, J., dissenting); Alfred E. Kahn, *Letting Go: Deregulating the Process of Deregulation* 101-103 (MSU Public Utilities Papers 1998); Alfred E. Kahn, *Whom the Gods Would Destroy, or How Not to Deregulate* 3-16 (AEI-Brookings 2001).

[3] *In the Matter of Application by Qwest Communications International, Inc. for Authorization To Provide In-Region, InterLATA Services in the States of Colorado, Idaho, Iowa, Montana, Nebraska, North Dakota, Utah, Washington and Wyoming*, WC Docket No. 02-314, Memorandum Opinion and Order, 17 FCC Rcd 26303, at ¶ 175 (Rel. Dec. 23, 2002).

As hearing commissioner, I presided over the Colorado TELRIC proceeding, and set Qwest's wholesale TELRIC-compliant rates along with my two commission colleagues. The Colorado TELRIC proceeding involved thousands of pages of pre-filed written testimony, 'dueling' forward-looking cost models, two weeks of hearing and written closing statements of position. The Colorado Public Utilities Commission issued orders of 119 and 91 pages, respectively in setting the TELRIC rates.

I offer this background as evidence of first-hand experience with TELRIC ratesetting. I have presided over a TELRIC docket. I have had to set TELRIC rates. This Commission deemed those rates compliant in the Qwest § 271 proceeding.

My comments here are prompted by my experience in presiding over and deciding a TELRIC rate case.

## III. The Real World Impossibility of TELRIC

TELRIC is less a concrete pricing methodology for state commissions to follow than an empty incantation to be recited at the beginning of a pricing order. Say "hypothetical forward-looking costs of an efficient carrier" a few times,[4] and proceed to the manipulation of cost model inputs until the rates seem right. This may seem a cynical view, but the practical impossibility of applying the TELRIC method leaves no other option. As the Commission notes in paragraph 7 of the NPRM, the difficulty with TELRIC is the excessively hypothetical nature of the inquiry. This difficulty is fatal because it makes principled decisionmaking impossible for the regulator. In turn, this invites the worst sort of regulatory gaming by the parties, who can justify a wide swath of

cost models and input assumptions with the rhetorical fig leaf that the assumptions reflect hypothetical, efficient, forward-looking network costs.

Nobel Laureate economist Ronald Coase distrusted 'blackboard economics' – economics where the perfect theoretical solution overlooks the institutional and epistemological context of regulatory decisionmaking.[5] TELRIC epitomizes 'blackboard economics' assumptions to the detriment of consumers and competitors in the emerging competitive communications marketplace.

In practice, TELRIC rate-setting has the analytical consistency of watery porridge. There is simply no place, or way, for a regulatory commission to evaluate the respective merits of the hypothetical forward-looking models. Faced with dramatically divergent assumptions in cost models, which yield dramatically different pricing outputs, there is simply no principled manner for a regulator to determine the 'right' TELRIC rate.

In paragraph 41 of the NPRM, the Commission asks for comment on the transparency and verifiability of the UNE pricing methodology. There is neither. The forward-looking cost models tendered by the respective sides in a TELRIC proceeding are prototypical "black box" computer models, thus assuring opacity and not transparency. Likewise, verifiability is impossible because the rates are premised on a series of assumptions…assumptions about the future that cannot be tested or falsified.

---

[4] *See, e.g., In the Matter of U S West Communications Inc.'s Statement of Generally Available Terms and Conditions,* Docket No. 99A-517T, Decision No. C01-1302, Commission Order ¶¶ II.C-D, pp. 11-13 (Colo. PUC, Rel.. Dec. 21, 2001).

[5] *See* R.H. Coase, *The Firm, the Market, and the Law* 28-29 (Chicago 1988):

> Economic policy involves a choice among alternative social institutions, and these are created by the law or dependent on it. The majority of economists do not see the problem in this way. They paint a picture of an ideal economic system, and then, comparing it with what they observe (or think they observe), they prescribe what is necessary to reach this ideal state without much consideration for how this could be done. The analysis is carried out with great ingenuity but it floats in the air. It is, as I have phrased it, "blackboard economics".

The perfectly adequate rebuttal to any TELRIC cost model is: "says you." The most problematic part to this is that even the decisionmaker's rates are subject to this objection.

The rebuttal to these objections to TELRIC is usually twofold: first, all forward-looking ratemaking involves predictive judgments; and, second, TELRIC resolves the traditional informational asymmetries present in rate cases.

Regulators often must make predictive judgments. But, there are predictive judgments and then there are predictive judgments. The hypothetical, efficient network standard of TELRIC involves too much prediction, with too little ability to know whether those predictions are accurate. By contrast, consider forward-looking ratemaking done using the future test year in a rate-of-return case. In this case, the regulator has the starting point of the regulated firm's actual costs from which to predict its future costs.[6] Furthermore, the prediction of future costs is tethered to a known time horizon. Therefore, an actual forward-looking cost rate-setting exercise relies on predictive judgments that have some attachment to real, known costs.

Admittedly, TELRIC resolves the traditional rate-setting problems of informational asymmetry between the regulator and regulated entity. The traditional informational asymmetry occurred where the regulated entity possessed better information than the regulator and thus was able to exploit that fact to its advantage. TELRIC replaces that information with a rate-setting method where *no* party has any verifiable information about the costs of a hypothetical, efficient network. This is no

[6] To be sure, this raises the age-old problems of cost padding and information asymmetries. There are no perfect solutions when regulators are asked to set rates, and regulators must simply do their best to be conscious of the weaknesses of different methods. In the end, of course, under the Act, the goal is for regulators to get out of the rate-setting business.

great gain. Indeed, it is an invitation to wide variability in TELRIC rates because no party has any verifiable assumptions to which a decision can be anchored.

What will be the fill factor in a forward-looking network? What will be the plant mix? The depreciation rate? The amount of structure sharing? The average drop lengths? The total installed factor? No one can say for sure. Indeed, plausible assumptions can justify a variety of cost model inputs.[7] But none of these assumptions is falsifiable. Further, idiosyncratic changes to some of these assumptions can have dramatic effects on the ultimate rates. Therefore, the decisionmaker is left adrift to make a series of "best guesses" and jigger cost inputs so that rates come out in some sort of nebulous TELRIC comfort zone.

In the end, then, TELRIC rate-setting brings back the worst of the old rate-of-return habits of rate case gaming. In rate-of-return cases, the utility came in with inflated and padded estimates of costs; the utility commission staff came in with depressed estimates of the same; the commission then derived rates by meeting these assumptions somewhere in the middle. A TELRIC proceeding duplicates this dynamic, but with less discipline. Furthermore, TELRIC cost modeling even removes the option of Solomonic regulatory decisionmaking – namely, to split the difference between the divergent cases. With TELRIC, the rate gulf is inevitably so wide that there is no way to do both: endorse a cost model and then manipulate the model to get "split the difference" rates.

---

[7] These assumptions can dramatically affect the final rates. In the Colorado proceeding, plant mix, structure sharing and average drop length adjustments to the cost model changed the ultimate TELRIC rates by non-trivial amounts. *Compare*, Decision No., C01-1302 (Commission Order) cost inputs with Decision No. C02-409 (Commission RRR Order), Docket No. 99A-517T, *cite supra.*

A typical defense of TELRIC is as follows: "If you set TELRIC rates properly, then salutary things follow."[8] It is impossible to set TELRIC rates properly. It is an epistemological impossibility. It is a methodological impossibility. The regulator simply cannot have adequate knowledge to get TELRIC rates *right.* That is the sole point of these submitted comments.

## IV. Secondary Considerations Predominate

There is no analytically rigorous way for a state commission to accomplish TELRIC pricing. Thus confronted with a host of plausible but divergent assumptions, secondary considerations tend to predominate in fact during TELRIC rate-setting. Specifically, TELRIC rate-setting becomes a dual exercise of staying within the range of previously-set TELRIC rates in other jurisdictions, and ensuring adequate margin under the retail rates to induce competitive entry using the UNE platform.

Notably, neither of these signposts is true to the stated methodology for TELRIC rate-setting. Ostensibly, TELRIC is a "bottom-up" forward-looking costing and pricing method for each unbundled network element. Because this cannot be done with any certainty, these secondary considerations end up driving the rate-setting process.

In particular, the "quest for margin" under the still-regulated retail rates tends to predominate in TELRIC proceedings. The plasticity of the input assumptions allows manipulation of TELRIC rates until the "desired" margin can be created. This is nothing but questionable industrial policy masquerading as a costing proceeding.

---

[8] *See, e.g.,* Kevin A. Hassett, Zoya Ivanova & Laurence J. Kotlikoff, *Increased Investment, Lower Prices: The Fruits of Past and Future Telecommuncations Competition* (AEI Sept. 2003), *available at*

## V. What to do?

TELRIC can be interred thoroughly as a theoretical[9] and -- it is hoped through these comments -- a practical matter.[10] This does not answer the question of how this Commission is to alter TELRIC. The Commission tentatively concludes that TELRIC rules should more closely account for the real world attributes of an incumbent's network. This is exactly right.

There are two species of problems the Commission should address in TELRIC reform. First, the Commission should prescribe a more predictable and verifiable forward-looking methodology. Second, the Commission should take steps to minimize the hazards from regulatory gaming that the current TELRIC method invites.

On the first issue, the Commission can better prescribe and moor a forward-looking cost methodology to actual costs for the incumbent. Further, the Commission can consider a "costing cap" rate-setting method akin to price cap plans to minimize the comprehensive regulatory intervention that wholesale rate-setting now requires.

Second, the Commission should consider suggesting procedural methods to minimize the regulatory (and regulator) gaming that currently occurs in TELRIC proceedings. Specifically, rate-setting (using whatever costing methodology) might be better accomplished through baseball-style arbitration proceedings, rather than the current cost of hypothetical service method. Under this process, state commissions would still

---

http://www.aei.org/docLib/20030916_kotlikoffpaper.pdf.

[9] *See*, *e.g.*, Breyer & Kahn, *supra* n. 2.

[10] Though citation to one's own work has a whiff of self-loving grandiosity, the institutional context in which regulators operate has been something of an obsession to me. Therefore, *see also* Raymond L. Gifford, *Regulatory Impressionism: What Regulators Can and Cannot Do*, 2 Rev. Network Econ. 466 (Dec. 2003), *available at* http://www.rnejournal.com/articles/gifford-RNE_10_final.pdf; Raymond L. Gifford, "That is Not What I Meant at All: Assertive Modesty in Regulation," Address Before the Silicon Flatirons Telecommunications Program (Feb. 2, 2003), *available at* http://www.pff.org/publications/communications/pop10.6assertivemodesty.pdf.

have authority to decide rates, but without the wide latitude that exists now. Likewise, parties to cost proceedings would not have such strong incentives to make aggressive assumptions. While not specifically germane to the rate-setting methodology, a change in *practice* might well have as much salutary effect on current rate-setting as a change in method.

## VI. Conclusion

The Commission undeniably has thicker filings detailing the empirical reality of TELRIC. These comments are offered to establish the small point that TELRIC cannot be done in a principled manner. For this reason alone, it should be changed.

TELRIC is a regulatory abomination. It is an abomination, to my view, because it makes the entire regulatory process dishonest. Parties and the regulator are forced into pretending there is methodological rigor when there cannot be. Further, they are forced into pretending there is real, principled pricing going on when secondary, unspoken considerations drive the process.

The FCC should put an end to this exercise in 'blackboard economics' and consider a rate-setting method that has more methodological, real world integrity.

Respectfully submitted,

______________________________

Raymond L. Gifford
President
The Progress & Freedom Foundation
1401 H Street, NW
Suite 1075
Washington, DC 20005

December 16, 2003