On the Importance of Regulatory “Toughness”

A Response to Phoenix Center’s Assessment of the AT&T IP Transition Petition

Policy White Paper Prepared by

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Introduction and Background on AT&T's Petition

The Phoenix Center recently released a paper prepared by George Ford and Lawrence Spiwak[1] supporting AT&T's IP transition petition.[2] In that petition, AT&T requests that the FCC initiate deregulation trials that AT&T alleges are needed to facilitate the transition from time-division-multiplexing (TDM) based networks to Internet protocol (IP) based networks. The Ford/Spiwak paper includes an economic model. Based on the economic model, Ford/Spiwak conclude that the behavior of AT&T and other incumbent local exchange carriers (ILECs) will be constrained during the trials by the "toughness" of the FCC, which will oversee the trials. Ford/Spiwak also argue that ILECs will be on their "best behavior" during the trials, and that the FCC can use the "precedent" of the observed best behavior to design any regulatory constraints that are needed after the trials. Ford/Spiwak conclude that the only reason to oppose AT&T's petition is if one has a "lack of faith in the regulator"[3]—in other words, if one believes that the FCC will not be tough enough on AT&T during the trials. As will be discussed in more detail below, Ford/Spiwak's arguments do not stand up to scrutiny as they ignore core elements of AT&T's proposal. Notably, Ford/Spiwak overlook the fact that AT&T's proposal, by imposing a regulatory "blank slate," places the FCC in a position of relative weakness. Ford/Spiwak also ignore AT&T's proposal for FCC preemption of all *state* regulation.[4] Thus, AT&T's regulatory "blank slate" undermines the potential for regulatory "toughness," and, as will be discussed further below, significantly increases the risks associated with the trial deregulation proposal.

AT&T's Petition

In its petition, AT&T argues that unless it gains relief from "regulatory burdens," ILEC "incentives to invest in new or upgraded IP networks" will be reduced.[5] AT&T proposes a deregulatory trial with the following steps: (1) ILECs decide which wire centers to submit for study; (2) federal and state regulatory requirements are removed; (3) trial runs of the transition to "next-generation" services will take place, and (4) TDM "facilities and offerings" will be "retired" and replaced with IP-based "alternatives."[6] According to AT&T, these trials will help the FCC "understand the technological and policy dimensions of the TDM-to-IP transition," and to "identify regulatory reforms needed to promote consumer interests."[7] Key to the implementation of AT&T's plan is the elimination of all current regulatory requirements, including those imposed by Congress on the states and the FCC through the federal

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[1] "Searching for a New Regulatory Paradigm: A Comment on AT&T's Petition for Wire Center Trials," George S. Ford, Ph.D. and Lawrence J. Spiwak, Esq., February 25, 2013. Hereinafter, "Ford/Spiwak." Available at: http://www.phoenix-center.org/perspectives/Perspective13-01Final.pdf

[2] In response to AT&T's petition, the FCC opened a docket and solicited comments. See, *Pleading Cycle Established on AT&T and NTCA Petitions*, GN Docket No. 12-353, DA 12-1999, Released: December 14, 2012. Comments were filed on January 28, 2013 and Reply Comments were filed on February 25, 2013. AT&T's petition is available at: http://apps.fcc.gov/ecfs/document/view?id=7022086087

The author assisted AARP with its preparation of comments and reply comments in that docket. AARP did not fund this paper. Views expressed herein are the author's.

[3] Ford/Spiwak, p. 5.

[4] AT&T Petition, pp. 15-18. Among other factors, AT&T requests that the FCC suspend all carrier of last resort obligations, claim exclusive federal jurisdiction over all IP-based services, and suspend state and federal service discontinuance requirements.

[5] AT&T Petition, p. 5.

[6] AT&T Petition, pp. 1 &11-20.

[7] AT&T Petition, p. 1.

Communications Act. AT&T also requests that the FCC preempt any state regulatory authority that might impede the trials.[8] Thus, as noted by Ford/Spiwak, AT&T's proposal results in a regulatory "blank slate."[9]

Ford/Spiwak's Analysis of the Trial Period

Ford/Spiwak state that starting from a "blank slate" is valuable:

> AT&T proposes that the search for a new regulatory paradigm is best served by starting with a regulatory blank slate, thereby creating an environment where *market solutions* are allowed to emerge without the distortions of regulatory influences.[10]

While pointing to market solutions, Ford/Spiwak also assert that the tests will be conducted with "vigorous regulatory oversight."[11] They note that there will be a logical impact of this oversight:

> [G]iven regulatory oversight of the trials, participating firms are likely to be on their best behavior during these field experiments. As a result, these trials will provide significant evidence of industry "best" practices . . . leaving a trail of precedent applicable to a more widespread implementation of regulatory reform.[12]

Thus, Ford/Spiwak also argue that the regulatory "blank slate" will not result in unconstrained market behavior on the part of the ILECs that partake in the trials. Rather, because of there will be ongoing regulatory oversight of the trials, the participating firms will be on their "best behavior." According to Ford/Spiwak, the FCC can then establish the essential regulation that should apply going forward, based on the "precedent" established during the trials. Thus, regulatory influences will be present during the trials and, according to Ford/Spiwak's economic model, will shape the outcome. Therefore, the "solutions" that emerge are not pure "market solutions"—they are regulatory solutions. A key question, which can be considered using Ford/Spiwak's economic model, is whether it is reasonable to expect that the trials will result in good regulatory solutions. As explained below, Ford/Spiwak's model shows that good regulatory solutions are most likely to result from regulatory "toughness" during the trials. Thus, one key question relates to the degree of regulatory toughness that can be reasonably expected during the trials.

The Ford/Spiwak Economic Model

Ford/Spiwak offer an economic model to support their position. The Ford/Spiwak model is simplified and based on a single-product monopoly firm. The Ford/Spiwak model enables comparative static analysis of the expected price charged during the trials in the short run, but does not contribute to Ford/Spiwak's conclusions about the long-term behavior of the ILEC, i.e., in the period after the trial. As the old saying goes "there is always a larger game," and even if one accepts the conclusion that ILECs will be on "best behavior" during the trial, consideration

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[8] AT&T Petition, pp. 11-20.
[9] Ford/Spiwak, p. 2.
[10] Ford/Spiwak, p. 2, emphasis added.
[11] Ford/Spiwak, p. 1.
[12] Ford/Spiwak, p. 2.

of incentives and outcomes after the trial are equally, if not more, important. As will be discussed further below, Ford/Spiwak's arguments regarding long-term outcomes are anything but convincing.

Using their model, Ford/Spiwak develop a benchmark outcome that, not surprisingly, indicates that absent any regulatory constraint, the price charged by the ILEC will be higher once regulatory constraints are lifted.[13] Ford/Spiwak then model the impact of regulatory oversight during the trials on the impact of the pricing decisions of the firm and demonstrate that:

> [T]he optimal price under [regulatory] uncertainty about the regime change could be above, below, or equal to the price found under the less-profitable, existing regulatory scheme.[14]

Thus, according to the Ford/Spiwak model, the outcome that results will depend on the regulatory oversight of the trial. Ford/Spiwak go on to modify their model to provide more precise assumptions regarding the behavior of the regulator. Ford/Spiwak demonstrate that if the regulator injects a sufficient level of uncertainty regarding the ultimate outcome of the regulatory transformation, the firm will choose the same price that it did when regulation was in place.[15] Furthermore, Ford/Spiwak model the case of a "tougher" regulator, and conclude:

> [W]hen the regulator is more sensitive to the price, the firm sets an even lower price in order to avoid the strong threat of sticking with the existing and less-profitable regulatory regime.[16]

Ford/Spiwak continue:

> [T]he observed behaviors (whether in terms of price or other choices) in the AT&T-proposed trials are dependent on the "toughness" of regulatory oversight. Since the regime change sought by AT&T depends on the consent of the watchful regulator, the trials will establish a precedent of favorable terms and conditions for consumers, rivals, and related firms.[17]

Because regulatory "toughness" is so important to Ford/Spiwak's conclusions, it is puzzling that Ford/Spiwak do not consider the impact of the removal of all regulation, including the preemption of state regulation by the FCC, on the regulator's ability to be "tough." In other words, built into AT&T's proposal is a structural component that rigs the game in favor of ILECs by forcing the "regulator" (i.e., the FCC) into a position of weakness (by removing federal regulation) and also eliminating "watchful regulators" at the state level.

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[13] Ford/Spiwak, p. 3, equation (3).
[14] Ford/Spiwak, p. 4. See also equation (5) in Ford/Spiwak, p. 4.
[15] Ford/Spiwak, p. 4, equations (6) and (7).
[16] Ford/Spiwak, p. 4, see also equations (8) and (9) on that page. While Ford/Spiwak do not elaborate, it is not clear why the firm would choose to set a lower price, and reap lower profits, for the trial, unless the firm also believed that prices and profits would be higher in the future. The issue of longer-term behavior of the firm and the ability of the regulator to address it are discussed in the following section.
[17] Ford/Spiwak, p. 4.

The favorable outcome predicted by Ford/Spiwak's economic model depends on the regulator being "tough," and the "toughness" of the FCC is undermined after it grants AT&T the regulatory relief it requests. Creating the "blank slate" forces the FCC to lay down its regulatory tools, and whether or how quickly those tools could be picked up is unknown. Furthermore, the FCC would also have to make up for all of the lost "toughness" associated with the elimination of state oversight. Thus, the deck is stacked against toughness from the get-go.[18] Furthermore, even if the FCC could be tough enough in the short term to make up for the lack of state regulatory oversight during the limited trials, whether the FCC would be able to keep up that level of oversight when the setting shifted from limited trials to widespread implementation is doubtful. The ILECs might earn lower profits under a "super tough" FCC during the trials, and then increase prices and profits following the trials, when the FCC's ability to police would be constrained.[19]

In conclusion on the regulatory "toughness" issue: Ford/Spiwak argue that critics of AT&T's proposal who point to the potential for the ILECs to be on their "best behavior" during the trials as a reason to oppose the trials are wrong, and that this "best behavior" is actually a reason to pursue the experiment, as the "best behavior" will establish "precedent."[20] However, as discussed above, due to the reduction in regulatory "toughness" that is built into AT&T's proposal, "best behavior" is not likely to be achieved, and any "precedent" that is established during the trials will be less than optimal.

Enforcement in the Post-Trial Period—Special Access Markets Illustrate the Problem

As their model only addresses the trial period, Ford/Spiwak offer an alternative explanation as to why ILECs will not misbehave in the post-trial period. Ford/Spiwak argue that any fears regarding the potential for future misbehavior of the ILECs are misplaced:

> But what of the larger argument that firms will only behave nicely during the trials to get the FCC to grant AT&T's petition in toto, but once granted firms will then show their true stripes and the FCC will be powerless to stop them? Again, these fears are misplaced.
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> Why? Because it is black letter administrative law that the FCC can change its mind and reregulate, provided it articulates a rational reason for doing so.[21]

In other words, if things do not work out after the trials, the FCC can simply reregulate.

It is interesting that Ford/Spiwak point to the FCC's recent actions regarding special access markets as evidence of the FCC's ability reregulate so as to reverse harms arising from deregulation.[22] The FCC granted ILECs pricing flexibility in special access markets in 1999.[23]

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[18] That the deck is stacked against tough regulation in the AT&T proposal is not surprising. It would be surprising if AT&T had submitted a plan that it expected would result in lower profits over the long term.
[19] This point is pursued further in the following section.
[20] Ford/Spiwak, p. 4.
[21] Ford/Spiwak, p. 5.
[22] Ford/Spiwak, p. 5.

Following that decision, concerns that the special access pricing flexibility was prematurely granted were voiced widely. In fact, none other than Messrs. Ford and Spiwak expressed their concerns regarding problems in the FCC's deregulation of special access markets in 2003:

> [T]he Commission's deregulatory scheme for Special Access has produced substantial and sustained price increases for Special Access services where pricing flexibility is granted. Based on the results of an econometric model, these price increases are found to be the consequence of ILEC market power rather than price adjustments reflecting costs. The empirical model suggests that Special Access service is priced at about three times incremental cost, and this result is in line with other recent studies of market power in Special Access markets (e.g., Rappaport, Taylor et al., 2003), which find that the Bells receive a 40 percent return on Special Access revenues of $13.3 billion.
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> This evidence suggests that while admittedly imperfect prognostications about competition and market power may be acceptable ex ante, continued agency review of incumbent market power is not only warranted, but virtually mandatory. *Further, when abstract measures of competition are found, ex post, to be inadequate checks on market power such as in the case of Special Access services, the continued use of such abstractions by regulatory agencies should be immediately reviewed and potentially eliminated, particularly where such failure has a significant adverse impact on consumer welfare and a deleterious effect on U.S. telecoms competition and, by extension, the economy overall.*[24]

One can only agree that ex ante prognostications about market power should not translate into an ex post abdication of regulatory oversight, and for the appropriateness of immediate review. But the FCC's response to the special access problem was anything but immediate.

While Ford/Spiwak now indicate that they believe that the FCC's recent actions taken regarding special access markets are "draconian,"[25] there is no question that Ford/Spiwak believed that such action should have been taken ten years ago. This illustrates a very important point relevant to Ford/Spiwak's current statement that it is "black letter administrative law" that the FCC can change its mind and reregulate. In theory it can, but key unanswered questions include how long will it take to reregulate, and what sort of damage will be done in the interim period? The problems with special access markets that Ford/Spiwak illustrated in 2003 have yet to be resolved by the FCC. Ford/Spiwak's 2003 study summarizes some of the negative impacts of special access market failure:

> [A] reduction in Special Access prices of 42%, commensurate with an 11.25% rate of return on total investment, would generate 64,000 new jobs and $11.6 billion in new

[23] *In the Matter of Special Access for Price Cap Local Exchange Carriers; AT&T Corporation Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services.* WC Docket No. 05-25, RM-10593, Report and Order, August 22, 2012, ¶11.

[24] George S. Ford, PhD, Lawrence J. Spiwak, Esq. "Set It and Forget It? Market Power and the Consequences of Premature Deregulation in Telecommunications Markets," Phoenix Center Policy Paper Series, July 2003, emphasis added. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=487464

[25] Ford/Spiwak, p. 5.

> economic activity in the first year alone, and the accumulated number of new jobs created would double to 132,000 in the second year (equaling a $14.5 billion cumulative impact on the U.S. economy) as the benefits of the price reduction flows through the economy.[26]

Compound these losses over the intervening ten years and the negative impact of this market failure is substantial, a point which the FCC now apparently recognizes.[27] The FCC's delay in response does not assuage concerns regarding potential future regulatory responses to observed market failures in the period following AT&T's "blank slate" trials. Not only will state regulators be wiped from the slate, but it may take a very long time for remedial action to be taken. These factors cast additional doubt on Ford/Spiwak's conclusion that long-term concerns are overstated due to the potential for reregulation.

Conclusion

With regard to AT&T's proposed trials, Ford/Spiwak's argument that short-term "best behavior" can be easily translated into a long-term regulatory solution is not reasonably supported by their economic model, and these authors are well aware of the potential for long-term market failure, as illustrated by their previous discussion of special access markets. The presence of a "tough" regulator is a good idea, but AT&T's plan stacks the deck against regulatory toughness.

There is no question that the transition to all-IP networks will happen, in fact, ILECs other than AT&T have been able to make the transition without the relief that AT&T requests.[28] It is also likely that a reasoned review of regulatory requirements makes sense in light of this most recent technology transition. However, as is demonstrated by the Ford/Spiwak model, placing regulators in a position of weakness is not a reasonable approach to ensure that important outcomes, including technology-neutral statutory mandates associated with affordability, service quality, and universal service, are achieved. It is also important for the states to be involved in the TDM-to-IP transition, so that state and federal statutory obligations can be fulfilled as the technology transformation unfolds.

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[26] George S. Ford, PhD, Lawrence J. Spiwak, Esq. "Set It and Forget It? Market Power and the Consequences of Premature Deregulation in Telecommunications Markets," Phoenix Center Policy Paper Series, July 2003, p. 30 (Citing to a study done by Rappaport and Taylor).

[27] "[T]here is compelling evidence that our current pricing flexibility rules are not properly matching relief to such areas, combined with allegations that this mismatch is causing real harm to American consumers and businesses and hindering investment and innovation." *In the Matter of Special Access for Price Cap Local Exchange Carriers; AT&T Corporation Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services.* WC Docket No. 05-25, RM-10593, Report and Order, August 22, 2012, ¶3.

[28] As the National Exchange Carrier Association notes in its Comments on the AT&T Petition: "It is also unclear at this point why permission or regulatory relief from the Commission would be needed to conduct a "technical" trial; many carriers are already converting their networks to IP technology via the installment of softswitches and fiber. Moreover, nothing in the current regulatory framework precludes carriers from interconnecting on an IP-enabled basis. Indeed, RLECs currently have tariff provisions in place to permit such interconnection in short order." NECA and OPATSCO Comments in GN 12-353, January 28, 2013, p. 11.