

Progress and Regress on InterLATA Competition

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I. INTRODUCTION

Over sixty-six billion dollars were spent in 1997 on interstate and international long-distance telecommunications services.¹ MacAvoy and Taylor argue that, despite price decreases, this telecommunications market is characterized by prices that exceed competitive levels because the price decreases have not kept pace with decreases in costs.² Some counter that this conclusion results from incorrect measurement of prices, but Taylor and Zona reexamine the question from many perspectives and still conclude “that it is very unlikely that the interstate long-distance market is effectively competitive.”³ Due to the sheer size of the market, even a *potential* failure of competition must be taken seriously. Departures from competitive outcomes can have enormous welfare consequences.⁴ This was one motivation behind passage of the Telecommunications Act of 1996 (Act),⁵ which, among other things, removed the legal prohibition that prevented Bell Operating Companies (BOCs) from providing certain interLATA (long-distance) services.⁶ The theory is that, under the right conditions, the BOCs could inject vigorous new competition into interLATA markets and could also compete to provide new services for which there is pent-up demand, such as one-stop shopping for telecommunications services.⁷

Section 271 of the Act outlines the process that BOCs use to obtain

1. See James Zolnierek et al., *Long-distance Market Shares Fourth Quarter 1998* at 18 tbl.3.4 (visited Nov. 16, 1999) <http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/mksh3q98.pdf>.

2. See PAUL W. MACAVOY, *THE FAILURE OF ANTITRUST AND REGULATION TO ESTABLISH COMPETITION IN LONG-DISTANCE TELEPHONE SERVICES* 1-6 (1996); see generally William E. Taylor & Lester D. Taylor, *Postdivestiture Long-distance Competition in the United States*, 83 AM. ECON. REV. 185 (1993).

3. William E. Taylor & J. Douglas Zona, *An Analysis of the State of Competition in Long-distance Telephone Markets*, 11 J. REG. ECON. 251, 227-55 (1997).

4. See Paul W. MacAvoy et al., *Should Local Telephone Companies be Allowed to Enter the Long-distance Market? A Regulatory Conundrum* (Feb. 1999) (unpublished manuscript, on file with the *Federal Communications Law Journal*); see generally Paul J. Hinton et al., *An Analysis of the Welfare Effects of Long-distance Market Entry by an Integrated Access and Long-distance Provider*, 13 J. REG. ECON. 183, 183-96 (1998).

5. Pub. L. No. 104-104, 110 Stat. 56 (codified at scattered sections of 47 U.S.C.).

6. See 47 U.S.C. § 151 (Supp. II 1996).

7. See Harold Ware, *Competition and Diversification Trends in Telecommunications: Regulatory, Technological, and Market Pressures*, 13 J. REG. ECON. 59 (1998).

relief from their line-of-business restriction on interLATA services.⁸ BOCs must apply on a state-by-state basis to the Federal Communications Commission (FCC) for permission to offer interLATA services, and the FCC must render its decision within ninety days.⁹ The FCC may not grant permission unless it finds that four broad conditions are met.¹⁰ First, the BOC must either provide access and interconnection to its network pursuant to agreements with competing providers of local exchange services or have received no requests for access and interconnection.¹¹ The former is called a "Track A" application, while the latter is known as "Track B."¹² Second, the BOC must satisfy a competitive checklist, either through its interconnection agreements or through a statement of generally available terms for access and interconnection (SGAT).¹³ Third, the BOC must provide its interLATA services through a separate affiliate that meets certain structural requirements and nondiscrimination safeguards.¹⁴ Fourth, BOC provision of interLATA service must be "consistent with the public interest, convenience, and necessity."¹⁵

At this writing, the FCC has rejected five applications, approved one, and is currently reviewing one.¹⁶ Southwestern Bell was first to apply, requesting permission to offer interLATA service in Oklahoma.¹⁷ After deciding that Southwestern Bell met neither the Track A nor Track B requirements, the FCC denied this application.¹⁸ Ameritech Michigan followed and was the first application to pass the first condition.¹⁹ Although the FCC declared that Ameritech satisfied Track A, the FCC decided that several checklist items were not met and that Ameritech's long-distance

8. See 47 U.S.C. § 271(d)(3) (Supp. II 1996).

9. See *id.*

10. See *id.*

11. See *id.* § 271 (d)(3)(A)(i).

12. See Application by SBC Comm., Inc., Pursuant to Section 271 of the Comm. Act of 1934, as amended, to Provide In-region, InterLATA Servs. in Oklahoma, *Memorandum Opinion and Order*, 12 F.C.C.R. 8685, para. 1, 8 Comm. Reg. (P & F) 198 (1997) [hereinafter *Oklahoma Order*].

13. See 47 U.S.C. § 271 (d)(3)(A)(i).

14. See *id.* § 271 (d)(3)(B).

15. *Id.* § 271 (d)(3)(C).

16. See Ceci Stephens, *Common Carrier Bureau Current Issues: November Edition 1999* (visited Nov. 15, 1999) <http://www.fcc.gov/ccb/Crnttop.html#Section_271_Applications>.

17. See *Oklahoma Order*, 12 F.C.C.R. 8685, para. 1, 8 Comm. Reg. (P & F) 198.

18. See *id.* at para. 2.

19. See Application of Ameritech Michigan Pursuant to Section 271 of the Comm. Act of 1934, as amended, to Provide In-region, InterLATA Servs. in Michigan, *Memorandum Opinion and Order*, 12 F.C.C.R. 20,543, 9 Comm. Reg. (P & F) 267 (1997) [hereinafter *Michigan Order*].

affiliate did not satisfy the structural requirements and denied the application.²⁰ BellSouth submitted applications in South Carolina and Louisiana.²¹ In regard to the South Carolina application, the FCC decided that BellSouth did not meet the Track B requirements, did not seriously apply under Track A, and did not satisfy some checklist items.²² The FCC did not rule on whether BellSouth met Track A or Track B in Louisiana. Instead, the FCC relied exclusively on its decision that the checklist problems from South Carolina were also present in Louisiana.²³ BellSouth reapplied in Louisiana exclusively under Track A.²⁴ Despite much disagreement, the FCC declined to rule on whether BellSouth met the Track A requirements and denied the application due to ongoing checklist problems and some problems with the structural and nondiscrimination compliance of BellSouth's long-distance affiliate.²⁵ Bell Atlantic submitted an application in New York, which the FCC approved, and SBC submitted an application in Texas, which is currently under review.²⁶

The FCC and courts address the issues concerning section 271 application requirements in the six existing Orders,²⁷ decisions by the courts, as well as in other statements by the FCC. This Article considers

20. *See id.* at para. 6.

21. *See* Application of BellSouth Corp., et al. Pursuant to Section 271 of the Comm. Act of 1934, as amended to Provide In-region, InterLATA Servs. in S.C., *Memorandum Opinion and Order*, 13 F.C.C.R. 539, paras. 539, 541, 10 Comm. Reg. (P & F) 870 (1998) [hereinafter *South Carolina Order*]; Application of BellSouth Corp., et al. Pursuant to Section 271 of the Comm. Act of 1934, as amended, to Provide In-region, InterLATA Servs. in La., *Memorandum Opinion and Order*, 13 F.C.C.R. 6245, 11 Comm. Reg. (P & F) 328 (1998) [hereinafter *Louisiana Order*].

22. *See South Carolina Order*, 13 F.C.C.R. 539, paras. 8-9, 10 Comm. Reg. (P & F) 870.

23. *See Louisiana Order*, 13 F.C.C.R. 6245, para. 1, 11 Comm. Reg. (P & F) 328.

24. *See* Application of BellSouth Corp., BellSouth Telecomms., Inc., and BellSouth Long-distance, Inc., for Provision of In-region InterLATA Servs. in La., *Memorandum Opinion and Order*, 13 F.C.C.R. 20,599, 13 Comm. Reg. (P & F) 1082 (1998) [hereinafter *Louisiana II Order*].

25. *See Louisiana Order*, 13 F.C.C.R. 6245, para. 55, 11 Comm. Reg. (P & F) 328.

26. *See* Application by Bell Atlantic N.Y. for Authorization Under Section 271 of the Comm. Act to Provide In-region, InterLATA Serv. in the State of N.Y., *Memorandum Opinion and Order*, FCC 99-404, 1999 WL 1243135 (Dec. 22, 1999) [hereinafter *New York Order*]; Comments Requested on Application by SBC Comm. Inc. for Authorization Under Section 271 of the Comm. Act to Provide In-region InterLATA Service in the State of Tex., FCC Public Notice DA00-37 (Jan. 10, 2000), available at <http://www.fcc.gov/Bureaus/Common_Carrier/Public_Notices/da000037.txt>.

27. *See New York Order*, FCC 99-404, 1999 WL 1243135; *Louisiana Order II*, 13 F.C.C.R. 20,599, 13 Comm. Reg. (P & F) 1082; *Louisiana Order*, 13 F.C.C.R. 6245, 11 Comm. Reg. (P & F) 328; *South Carolina Order*, 13 F.C.C.R. 539, 10 Comm. Reg. (P & F) 870; *Michigan Order*, 12 F.C.C.R. 20,543, 9 Comm. Reg. (P & F) 267 (1997); *Oklahoma Order*, 12 F.C.C.R. 8685, 8 Comm. Reg. (P & F) 198 (1997).

the FCC's positions on most of these issues and evaluates whether these positions make economic sense and are consistent with the Act. To provide a foundation for considering these issues, Part II reviews the basic economics of BOCs' entry into interLATA markets. Part III presents the most contentious issues, while Part IV addresses related issues. A few differences between the current and former FCC commissioners surface in this evaluation. Part V summarizes the FCC's sound positions and advice for future BOCs' applications.

This Article does not evaluate the entire section 271 process. Many parties—including industry, regulators, academics, and legislators—bear some responsibility for the fact that nearly four years passed from the time the Act became law before any BOC gained relief from its line-of-business restriction. The actions of these parties notwithstanding, the present purpose is a much more modest review of *only* the basic economics and decisions issued by the FCC. On this, the Author reaches two broad conclusions. First, the federal regulators have performed admirably with regard to checklist compliance (except for the emphasis on TELRIC pricing and the “pick and choose” rule) and structural/nondiscrimination safeguards. Second, the FCC's performance on Track A/B compliance and public interest issues is less impressive. The pages that follow provide the rationale for these conclusions.

II. ECONOMICS OF BOCs' ENTRY INTO INTERLATA MARKETS

Essentially, the economic rationale for allowing BOCs' entry into interLATA markets is that free and open competition brings about the lowest possible prices and a mix of services that is as closely aligned with consumers' preferences as possible.²⁸ The 1982 consent decree imposed the line-of-business restriction only on BOCs after the court found that as long as local exchange service providers were allowed to sell long-distance service, competition in long-distance service could not be free and open.²⁹ This view was a product of the former integrated Bell System's alleged anticompetitive tactics toward its emerging rivals.³⁰ These tactics generally involved the use of the local network to accomplish a Bell System policy.³¹ Although there are many variants for the economic analysis, this Article places these tactics into two broad categories: tie-in sales and raising rivals'

28. See ANDREU MAS-COLELL ET AL., MICROECONOMIC THEORY 326 (1995).

29. See *United States v. AT&T*, 552 F. Supp. 131 (D.D.C. 1982); *aff'd*, *Maryland v. United States*, 460 U.S. 1001 (1983).

30. See B. DOUGLAS BERNHEIM & ROBERT D. WILLIG, THE SCOPE OF COMPETITION IN TELECOMMUNICATIONS 6-27 (1996).

31. See *id.*

costs. Today, the economic arguments against BOCs entry into interLATA markets can still ultimately be attributed either to one of these two tactics or to the pursuit of the further policy goal of giving BOCs' incentives to reduce barriers to entry into the local exchange business.

A. *Tie-in Sales*

A tie-in sale is a seller-imposed restriction requiring a purchaser interested in purchasing one product from the seller to buy both of the seller's products.³² In its simplest form, a tie-in sale is imposed by a monopoly seller of one product when it dictates to largely homogeneous purchasers that the monopoly-supplied product—the “tying” good—can only be bought if the purchaser also buys from the monopoly supplier a second, more competitively-supplied, product—the “tied” good.³³ In this way, the monopolist is thought to “extend the monopoly” to the more competitive market, thereby enabling the monopolist to charge a higher price for the tied good.³⁴ For example, concern might arise that a BOC would only sell its monopoly-provided local exchange service if a consumer agreed to buy, at a premium, the more competitively-supplied long-distance service from the BOC.³⁵

While this story was intuitively appealing and initially adopted by the courts as an explanation for anticompetitive conduct, closer scrutiny reveals that this situation may provide no motive for the monopoly supplier to tie its sales. Any attempt to charge a premium for the tied good is viewed by consumers as an add-on to the price of the tying good because consumers can always purchase just the tied good from the competitive suppliers.³⁶ Hence, the combination of this add-on and the price charged for the monopoly-supplied good cannot exceed the amount consumers are willing to pay for the monopoly-supplied good.³⁷ If it does, consumers will simply forego the monopoly-supplied good and buy the other good from a competitive supplier.³⁸ Thus, if consumers are largely homogeneous, the monopolist cannot extract any more profit by tying than it can by simply charging the most consumers are willing to pay for the monopoly-supplied product and imposing no tying restrictions.³⁹

32. See DENNIS W. CARLTON & JEFFREY M. PERLOFF, *MODERN INDUSTRIAL ORGANIZATION* 467 (2d ed. 1994).

33. See *id.* at 470.

34. See *id.*

35. See *id.* at 476-77.

36. See *id.* at 473.

37. See *id.* at 473-74.

38. See *id.*

39. See *id.* at 473.

The failure of this simple story to explain tying behavior has led to the study of what will actually lead to a tie-in sale. Not all of the objectives identified in the literature apply to potential BOCs' behavior. Indeed, the most basic tying story, that a BOC would refuse to sell local exchange service unless a consumer buys long-distance from the BOC, is largely irrelevant because existing regulations prohibit this behavior. To further the proper categorization and analysis of the allegations of tying in the FCC's section 271 Orders, this Article lists the main objectives. The six main objectives are as follows.⁴⁰ The first objective is to *achieve efficiency through scope economies either in production or purchasing*.⁴¹ This is welfare-enhancing and occurs with such frequency that it is usually not even recognized as a tie-in sale.⁴² Any assembled product can be viewed this way, such as a car or the fact that shoes are always sold with laces. Either product could be sold in its constituent parts, but it would be inefficient to do so. This objective should generally be of no concern to regulators and antitrust authorities.

The second objective is to *evade regulations*.⁴³ Suppose, in the simple story above, the monopolist is price regulated so that it cannot extract full monopoly profit from sales of the tying good. Then a tying policy that forces consumers to buy the tied good at inflated prices in order to obtain the tying good gives the monopolist a way to obtain its monopoly profit despite regulations designed to protect consumers. This objective should be of great concern to regulators.

The third objective is to *grant a secret price reduction*.⁴⁴ In oligopoly markets, there is often an incentive for sellers to cut price if they can do so without stimulating a matching price reduction by rivals. One way to do this is to sell a second good at below-market prices, along with the oligopoly-supplied good, thereby effectively reducing the price of the oligopoly-supplied good. For this to be successful, it must be difficult for rivals to observe sales of the second good. Since this strategy enhances consumer welfare through lower prices, it should generally be of no concern to regulators and antitrust authorities.

The fourth objective is to *assure quality*.⁴⁵ If the quality of one good is affected by the quality of another good, then a seller can indicate to consumers that it is a high-quality supplier, and thereby charge a higher

40. *See id.* at 471-79.

41. *See id.* at 467.

42. *See id.*

43. *See id.* at 468.

44. *See id.* at 469.

45. *See id.*

price, if it only supplies the first good as part of a package with the second good. For example, since long-distance calls must traverse local networks, the quality of local service affects the quality of a long-distance call. Hence, a telecommunications supplier might require consumers to purchase its local service in order to obtain its long-distance service. In the telecommunications industry, this tie does not use the monopoly-supplied local exchange service to tie the competitively-supplied long-distance service, as the simple story above suggests. Rather, the tie works in exactly the opposite direction. This shows that the construction of a tie-in sale can reveal much about its objective, and hence the level of concern it should elicit from regulators and antitrust authorities. This objective for tying should be of no concern to regulators and antitrust authorities, since the higher price obtained through the tie-in sale merely reflects higher quality (although the presence of market power in either of the markets may be a legitimate source of concern irrespective of tying).

The fifth objective is to *price discriminate*.⁴⁶ In the simple story above, consumers were largely homogenous. If instead consumers have diverse views about the desirability of the monopoly-supplied good, there is no single price the monopolist can charge to extract the maximum profit from every consumer. A tie-in sale can allow the monopolist to price discriminate when the monopoly-supplied good is purchased in single units at the same time that multiple units of the tied good are purchased. For example, Xerox was once a monopoly supplier of photocopiers but faced competition from other suppliers of paper. Tying sales of its machines to sales of its overpriced paper allowed Xerox to extract a higher effective price for its machines from the purchasers who valued copying services the most, since such consumers are generally the largest users of paper. Such a policy must include a lower price for the monopoly-supplied good than would be charged in the absence of the tie, otherwise too many purchasers will simply elect to not buy. Thus, the tie-in benefits low-volume users at the expense of high-volume users. This outcome is characteristic of price discrimination. Some consumers benefit while other consumers are harmed, which means that any intervention by regulators or antitrust authorities involves a difficult weighing of one group's interests against the interests of another group.

The final objective is to *deter entry or induce exit*.⁴⁷ The intuitive idea that tie-in sales are anticompetitive stems from the notion that the tying firm will "extend its monopoly" to another market.⁴⁸ The assumption in the

46. *See id.* at 471-79.

47. *See id.* at 467 n.3.

48. *Id.* at 467.

above simple story is that this does not occur because the market for the tied good is assumed to be competitive and its structure is assumed to be unaffected by the tying restriction. Recently, Michael D. Whinston revisited the original intuition—tying is anticompetitive—by studying a model in which tying can materially affect the intensity of competition in the market for the tied good.⁴⁹ He found that tying can indeed result in market foreclosure and higher prices, provided: (1) the market for the tied good is an oligopoly producing under conditions of increasing returns; (2) the tying firm has the ability to credibly *precommit* to tying before setting its prices; and (3) the decision to participate in the market is made before prices are set.⁵⁰

The logic is that the tying firm credibly announces, in advance, that it will only offer its monopoly product as part of a bundle with its oligopolistically-supplied product. This causes the other oligopolists to realize that, unless they charge a lower price than planned, they will lose sales to the tying firm for those consumers who value the monopoly-supplied product. This realization, in conjunction with the higher costs associated with a smaller scale of operation, may cause the potential profitability of the oligopolists to drop so much that they choose not to participate in the market. Once this choice is made, the tying firm is then free to raise its price for the tied good even higher, thereby earning monopoly profit on *both* the tying good and the tied good and accomplishing the feared extension of monopoly. The oligopolists must *believe*, however, the tying firm's announcement, for otherwise they will simply choose to participate in the market, thereby presenting the tying firm with a *fait accompli* and forcing the tying firm to abandon its tying strategy as in the simple story above. In effect, the tying firm must have a visible way to precommit that it will only offer the products as a bundle, and it must not be considered possible or cost-effective for the tying firm to later escape this commitment. This objective for tying should be of great concern to regulators and antitrust authorities, since it reveals that there may indeed be an extension of monopoly objective for tying. In order to determine whether this objective exists, the tying firm's ability to sufficiently precommit to the tie, the timing of entry/exit decisions, and industry returns to scale must be assessed.⁵¹

Of these objectives, only two, five, and six are potentially welfare-reducing. For the particular case of BOCs' entry into interLATA markets,

49. See Michael D. Whinston, *Tying, Foreclosure, and Exclusion*, 80 AM. ECON. REV. 837, 838 n.4 (1990).

50. See *id.* at 839.

51. See *id.* at 839-40, 855.

all three of these objectives are reduced by either of two extant regulatory policies. First, long-distance equal access is a direct attack on the BOCs' ability to tie sales of local service to sales of long-distance service. Equal access regulations were phased-in as part of the 1982 AT&T consent decree and require that BOCs give the same access to all long-distance sellers.⁵² The question at hand is whether long-distance equal access rules are stringent enough to overcome objectives two, five, and six in the presence of a joint provider of both local and long-distance service. Although there is limited experience with this scenario, mostly positive experience with GTE and BOCs provision of cellular and information services suggests that existing equal access rules are adequate.⁵³ Since experience demonstrates that long-distance equal access is workable, except for ongoing problems with slamming, it seems unlikely that BOCs could impose a tie on consumers without incurring substantial regulatory backlash. BOCs today certainly cannot defend tying by resorting to the suspect arguments about technical and administrative feasibility and quality control that AT&T used before 1982.⁵⁴ These arguments should not be confused with the other beneficial objectives for tying. BOCs may indeed offer one-stop shopping bundles in order to utilize economies of scope in either production or purchasing, offer less-visible price reductions, or assure consumers of a quality bundle of telecommunications services. But, as discussed above, these objectives should be of no regulatory concern.

The second policy reducing undesirable objectives for tying is better characterized as the group of policies designed to introduce competition into the market for local exchange service. To the extent these policies are successful, BOCs lose their monopoly control over the tying good and with it their ability to impose a tie. Such policies have other attractions, since they may ultimately replace regulation of local exchange service with competition, eliminating the need for the traditional regulation at the retail level along with the need to regulate long-distance equal access.⁵⁵ But such policies are also proving very regulatory and litigious to implement, and, as

52. See *United States v. AT&T*, 552 F. Supp. 131 (D.D.C. 1982); *aff'd*, *Maryland v. United States*, 460 U.S. 1001 (1983).

53. See Testimony of Alfred E. Kahn & Timothy J. Tardiff at 61-69, Application of SBC Comm. Inc., S.W. Bell Tel. Co., and S.W. Bell Comm. Servs., Inc. for Provision of In-region, InterLATA Servs. in Mo. (Mo. Pub. Serv. Comm'n Nov. 20, 1998) (No. TO-99-227).

54. See BERNHEIM & WILLIG, *supra* note 30, at 14; see generally PETER TEMIN, *THE FALL OF THE BELL SYSTEM: A STUDY IN PRICES AND POLITICS* (1987).

55. See T. Randolph Beard et al., Regulation, Vertical Integration, and Sabotage 4 (Mar. 1999) (unpublished manuscript, on file with the *Federal Communications Law Journal*).

they are currently emerging, they simply replace regulation at the retail level with regulation at the wholesale level. As discussed above, however, even if these policies completely fail, BOCs can still be allowed to sell interLATA service with their tying objectives controlled as long as there are effective long-distance equal access policies. There may still be large benefits to opening local markets. It is just that any such benefits do not arise from better control of BOCs' incentives to tie.

B. *Raising Rivals' Costs*

One way to conceptualize the alleged anticompetitive tactics cited by critics of the former integrated Bell System is to view the tactics as variations on the common theme of trying to make it more costly for competitors to produce, while striving to increase prices the Bell System could charge and, in the extreme, enabling monopoly pricing.⁵⁶ The central tool for this is control of the local transport, switching, and distribution systems, since these systems have historically been essential for providing long-distance service.⁵⁷ Although this is changing (indeed, the FCC concluded in the 1998 *Order* affecting BellSouth's application in Louisiana that PCS providers might be considered competing providers of local exchange service for the purpose of meeting Track A requirements), there remains great concern over the BOCs' control of local exchanges.⁵⁸ Critics of the integrated Bell System allege that the Bell System tried to raise its rivals' costs by charging MCI higher prices for access than AT&T Long Lines, delaying entry through strategic use of the regulatory process, insisting on an unreasonably large number of access points for long-distance competitors, failing to negotiate in good faith, arbitrarily disconnecting competitors' lines or otherwise interfering with call completion, and generally making it time consuming for competitors to obtain access to facilities and conduct necessary work.⁵⁹

Since these tactics were so widespread in the final years of the integrated Bell System, little consideration was given to whether AT&T had *incentives* to raise its rivals' costs.⁶⁰ AT&T's behavior could only be explained by the presence of such incentives.⁶¹ Hence, the regulatory

56. See Mark Sievers, *Should the InterLATA Restriction Be Lifted? Analysis of the Significant Issues* app. 1 at 9 (July 6, 1994) (unpublished manuscript, on file with the *Federal Communications Law Journal*).

57. *Id.* at app. 1 at 8.

58. See *Louisiana Order*, 13 F.C.C.R. 6245, paras. 72-73, 11 Comm. Reg. (P & F) 328 (1998).

59. See Sievers, *supra* note 56, at app. 1 at 8-10.

60. See *id.* at app. 1 at 12.

61. See *id.*

solutions of the day focused on controlling AT&T's *ability* to raise its rivals' costs. Ultimately, the courts decided that regulation could not control this ability and removed the incentive through divestiture and the line-of-business restrictions. However, today BOCs' entry into interLATA markets is prospective and, although the BOCs' emerging rivals in local service markets and future rivals in long-distance markets allege many instances of this type of BOCs behavior, a lively debate has developed over whether BOCs even have incentives to engage in such behavior.

This literature is targeted toward the study of a BOC's discrimination against a rival provider of interLATA service. Some reinterpretation may yield insights into BOCs' discrimination against a competing local exchange carrier (CLEC), but the vertical relationship is bilateral in the local exchange market and thus the existing models do not fit this situation. For this reason, the raising rivals' cost debate is presented here in the context of interLATA competition, as it has emerged in the literature.

To understand this debate, assume that a BOC is authorized to provide interLATA service and indeed has some ability to raise rivals' costs. In current jargon, this is sometimes referred to as the ability to "sabotage" a rival.⁶² It might seem intuitively obvious that the BOC should then exercise this ability, but there are some potential tradeoffs for the BOC.⁶³ The main tradeoff cited in the literature is that BOCs earn substantial profits from access charges paid by their long-distance rivals for completion of calls on the local network, so any action taken by a BOC that reduces its rivals' long-distance output also reduces the BOC's profit.⁶⁴ The mere existence of access charges above cost raises rivals' costs, but, in the current scenario, these charges are levied by regulators, not BOCs, and so are only under indirect BOC influence through lobbying and regulatory proceedings.⁶⁵ In any case, the clear trend is toward reducing these charges.⁶⁶ For the BOC, lost access profit must be balanced against gains obtained in the long-distance market due to rivals' reduced competitiveness. There are eight key ingredients that determine this balance.⁶⁷

*The extent of product differentiation in long-distance services.*⁶⁸ If

62. See David Mandy, *Killing the Goose that May Have Laid the Golden Egg: Only the Data Know Whether Sabotage Pays*, J. REG. ECON. (forthcoming).

63. See *id.*

64. See *id.*

65. See FCC, *Trends in Telephone Service* at 4 tbl.1.2 (visited Jan. 17, 2000) <http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/trend298.pdf>.

66. See *id.*

67. See Mandy, *supra* note 62, at 4.

68. See *id.*

BOC long-distance services are viewed by consumers as very similar to other long-distance services, then the BOC can readily supplant the sales its rivals' lose due to sabotage with its own sales, thereby mitigating the effects of lost profits from access charges. Alternatively, if BOC long-distance services are viewed by consumers as dissimilar to other long-distance services, then the BOC may not be able to replace all of its rivals' lost sales with its own sales.

*The cost of carrying out sabotage.*⁶⁹ If it is inexpensive for the BOC to sabotage its rivals then, other things equal, the BOC will have greater incentive to pursue sabotage. Note that the BOC's cost of sabotage may consist of many components. The direct cost of issuing prices and standards that are costly for rivals, and refusing to negotiate, may be quite modest. The direct cost of interfering with call completion and generally making it time consuming for competitors to obtain access to facilities and conduct necessary work is probably more substantial, while the direct cost of engaging in lengthy negotiations and regulatory processes may be even greater. But all of these direct costs may be quite small compared to the potential gain from sabotage. Of more concern for the BOC is the indirect cost of regulatory backlash if its sabotage is convincingly revealed. This cost is likely to be large and virtually certain if the BOC engages in blatant sabotage, like charging access prices above the regulated prices or interfering with long-distance equal access. Note that this is an area in which the current situation does not parallel the predivestiture setting, since access charges are now completely regulated and substantial experience has been gained with long-distance equal access. These regulations make sabotage more costly for BOCs than it was for the integrated Bell System. Note also that an *inability* to engage in sabotage can simply be thought of as a *prohibitively high cost* of carrying out sabotage. By viewing things this way, both the BOCs' *incentive* and *ability* to sabotage their rivals can be captured through the cost of sabotage.

*The structure of production costs for long-distance services.*⁷⁰ If the marginal cost of providing long-distance service is increasing, then it becomes progressively more costly for the BOC to replace its rivals' long-distance service with its own. Hence the BOC may find it profitable to engage in some sabotage, but not to raise its rivals' costs so high that they exit the market. An extreme case of this occurs when the BOC has a capacity constraint in its production of long-distance services. This is akin to a marginal cost that suddenly becomes infinite, making further substitution of its rivals' long-distance service with its own long-distance

69. *See id.*

70. *See id.*

service impossible.

*The relative efficiency of the producers of long-distance services.*⁷¹ If the BOC has lower production costs for long-distance services than its rivals, then the profit the BOC can generate by selling a unit of long-distance service is greater than the profit (gross of access charges) its rivals can generate by selling that same unit. Hence, even if the BOC can capture all of its rivals' profits through access charges, the BOC prefers to sell the unit itself, and therefore the BOC might try to sabotage in order to shift sales to its own long-distance service. Alternatively, if the BOC is relatively inefficient in the production of long-distance services, then its rivals can generate more gross profit on each unit of long-distance service. If the BOC can capture more of this profit through access charges than it can generate by producing the long-distance service itself, then the BOC does not want to sabotage its rivals.

*The degree of autonomy granted to the BOC's long-distance subsidiary.*⁷² If decisions regarding the BOC's long-distance quantities, prices, and/or service mix are independent or quasi-independent of sabotage decisions, then the tradeoff between access profit and profit from long-distance sales will generally differ from the tradeoff confronting a fully vertically integrated firm. Without complete coordination, the extra profit the BOC can obtain by enhancing its own long-distance sales through sabotage may be more limited relative to the accompanying lost access profit. Moreover, if the BOC cannot completely insulate its long-distance subsidiary from the effects of sabotage then sabotage will harm its own long-distance sales.

*The intensity of competition in the market for long-distance services.*⁷³ If long-distance competition is intense, then the BOC has less potential to earn profit as a seller of long-distance services but also obtains more profit from its sales of access because intense long-distance competition drives up long-distance volume. Thus, intense long-distance competition discourages sabotage as it makes access sales a relatively more profitable activity for the BOC.

*The intensity of competition in the market for access.*⁷⁴ If there is intense competition for sales of access, then the BOC gains less from sabotage because sabotage will cause the purchasers of access (i.e., the sellers of long-distance services) to switch to alternative suppliers of access. Thus competition in the market for access discourages sabotage.

71. *See id.*

72. *See id.* at 5.

73. *See id.*

74. *See id.*

This observation provides another rationale for the policies, mentioned above, that are designed to introduce competition into the market for local exchange service, since sellers of local exchange service also provide long-distance access to their end-customers.

*The size of the profit margin on sales of access.*⁷⁵ A large profit margin on access sales (perhaps created by access price regulation) discourages sabotage, other things equal, since it makes the BOC's access sales relatively more profitable than its long-distance sales. This is somewhat paradoxical, since regulated prices that exceed costs are normally regarded as inefficient. Essentially, there are two sources of inefficiency here: sabotage and regulated access prices that exceed costs. A BOC has stronger incentives to create one of these inefficiencies, if it can, when the other is small.

Not surprisingly, the conclusions obtained regarding BOCs' ability and incentive to sabotage depend on the assumptions made on these eight points. Nicholas Economides presents the most straightforward model of BOCs sabotage. He assumes perfectly homogeneous long-distance products, absolutely free sabotage, constant marginal cost of long-distance production, identical efficiency of all firms in long-distance production (initially), fully-integrated long-distance and sabotage decisions, a quantity-setting oligopoly in the market for long-distance services, no competition in the market for access, and a positive fixed profit margin for access.⁷⁶ Not surprisingly, he finds that BOCs will severely sabotage their rivals to the point of driving them from the long-distance market.⁷⁷ Since sabotage is free and the BOC can expand its own output indiscriminately with no increase in marginal costs and no cost disadvantage *vis-a-vis* its rivals, the BOC clearly has no cost incentive to refrain from driving its rivals' costs up to the point where their production is unprofitable.⁷⁸ Moreover, since the BOC long-distance service is perfectly substitutable for the rival long-distance services and no access competition exists, no potential sales are lost if all rivals are driven out of the market.⁷⁹ Yet, if the BOC permits any rivals to remain in the market, it must share the profit with them in the quantity-setting oligopoly, obtaining some of its rivals' profit through the positive access margin while losing whatever profit accrues to the still-functioning rivals and losing profit due to double

75. *See id.*

76. *See* Nicholas Economides, *The Incentive for Non-Price [sic] Discrimination by an Input Monopolist*, 16 INT'L J. INDUS. ORG. 271 (1998).

77. *See id.* at 281.

78. *See id.*

79. *See id.*

marginalization.⁸⁰ Full vertical integration gives the BOC the requisite control to effect as much sabotage as it desires with no harm to its own long-distance sales. Thus, the conclusion that BOCs will unambiguously sabotage until the long-distance market is foreclosed.⁸¹

T. Randolph Beard, David L. Kaserman, and John W. Mayo change Economides model by introducing “mildly differentiated” long-distance products, a “competitive fringe” faced by BOCs in the provision of access services, and price rather than quantity competition for long-distance services.⁸² However, they impose an assumption that aggregate long-distance demand is invariant to prices.⁸³ Aside from the strong empirical evidence that this is incorrect, this assumption eliminates the very reason that differentiated long-distance products might matter to a BOC that is considering whether to engage in sabotage.⁸⁴ Under this assumption, there can be no lost sales if all rivals are driven out of the market and, predictably, Beard, Kaserman, and Mayo conclude that BOCs have incentives to engage in sabotage as long as the access competition is not too intense.⁸⁵

Economides extends his analysis to the case of heterogeneous efficiency between the BOC and its rivals in the production of long-distance services.⁸⁶ As expected, his basic conclusion does not change if the BOC is more efficient than its rivals.⁸⁷ Remarkably, however, Economides concludes that the BOC will engage in market-foreclosing sabotage even if the BOC is *less* efficient than its rivals in the production of long-distance services—no matter how much less efficient.⁸⁸ As a general theoretical matter, this conclusion cannot be correct because, as explained above, if the BOC is so inefficient that it can capture more of the long-distance profit through access charges than it can generate by producing the long-distance service itself, then the BOC does not want to sabotage its rivals. That is, even in Economides model, which assumes homogeneous long-distance products, completely costless sabotage for the BOC due to the constant returns in long-distance production, fully-integrated BOC, and positive profit margins in both the access and long-

80. *See id.*

81. *See id.*

82. Beard, *supra* note 55, at 11-12.

83. *See id.* at 13.

84. *See* LESTER D. TAYLOR, TELECOMMUNICATIONS DEMAND IN THEORY AND PRACTICE 143 (1994).

85. *See* Beard, *supra* note 55, at 24.

86. *See* Economides, *supra* note 76, at 281.

87. *See id.*

88. *See id.*

distance markets, if the BOC's efficiency disadvantage is large enough, then the incentive to sabotage disappears.⁸⁹ Thus, whether the BOC has incentive to sabotage rivals is an empirical matter that depends, among other things, on the relative efficiency of the BOC and its rivals. Dennis L. Weisman explicitly studies the case of a relatively inefficient BOC and presents various scenarios in which the BOC may choose not to engage in sabotage.⁹⁰ He finds that the BOC must be substantially less efficient than its rivals before the incentive to sabotage disappears and that this critical level of inefficiency increases as regulatory oversight becomes imperfect.⁹¹

Another paper by Weisman incorporates differentiated long-distance products, a cost of carrying out sabotage, potentially increasing marginal cost of long-distance, and potentially heterogeneous long-distance costs.⁹² With all of these complications, Weisman finds the BOC facing a tradeoff between access profits and long-distance profits, making the degree of sabotage less severe than in the Economides model.⁹³ Whether sabotage is costly, as assumed by Weisman, is challenged by David Reiffen.⁹⁴ Reiffen suggests sabotage may be carried out by degrading service, so that a BOC actually saves money by engaging in sabotage.⁹⁵ Weisman counters that the savings may be small compared to the cost of supplying different levels of service for the BOC and its rivals.⁹⁶

In two papers, David S. Sibley and Dennis L. Weisman assume homogeneous long-distance products and sabotage that is carried out without cost to the BOC. The first paper further assumes constant and homogeneous marginal cost of long-distance and a fully-integrated BOC.⁹⁷ In this framework, they study the incentive to engage in a small amount of sabotage and find that when BOC long-distance market share is low there is no incentive to conduct the first unit of sabotage because it causes lost

89. See generally Mandy, *supra* note 62 (identifying and analyzing the key industry characteristics that determine whether nonprice discrimination is likely).

90. See Dennis L. Weisman, Vertical Integration and Exclusionary Behavior in Network Industries 1-3 (Jan. 1999) (unpublished manuscript, on file with the *Federal Communications Law Journal*).

91. See *id.*

92. See Dennis L. Weisman, *Regulation and the Vertically Integrated Firm: The Case of RBOC Entry into InterLATA Long-distance*, 8 J. REG. ECON. 249, 250 (1995).

93. See *id.* at 261-62.

94. See David Reiffen, *A Regulated Firm's Incentive to Discriminate: A Reevaluation and Extension of Weisman's Result*, 14 J. REG. ECON. 79, 79-80 (1998).

95. See *id.*

96. See Dennis L. Weisman, *The Incentive to Discriminate by a Vertically Integrated Regulated Firm: A Reply*, 14 J. REG. ECON. 87, 88 (1998).

97. See David S. Sibley & Dennis L. Weisman, *The Competitive Incentives of Vertically Integrated Local Exchange Carriers: An Economic and Policy Analysis*, 17 J. POL'Y ANALYSIS & MGMT. 74, 74-93 (1998).

access profit, and due to the low market share, does not generate much long-distance profit.⁹⁸ Sibley and Weisman estimate the critical market share, above which the BOC benefits from sabotage, to be about twenty-one percent on average.⁹⁹ However, their paper does not address the optimal choice of sabotage when the degree of sabotage can be large.

The second paper focuses on severely increasing marginal cost of long-distance production in the form of BOC capacity constraints, which introduces both decreasing returns in long-distance production and heterogeneous costs across firms.¹⁰⁰ Like Economides, the analysis presented by Sibley and Weisman allows any choice of sabotage.¹⁰¹ The capacity constraints in this paper are one rationale for the assumed market share in the first paper.¹⁰² Analogous to the first paper, Sibley and Weisman find that when BOC capacity is low there is no incentive for the BOC to sabotage because the BOC has no productive capability to fulfill its rivals' lost sales.¹⁰³ In fact, under very severe capacity constraints the BOC may want to engage in reverse sabotage, if possible, by *reducing* its rivals' costs. Sibley and Weisman permit the BOC to acquire capacity over time and again find that once its share of the long-distance market exceeds about one-fourth the incentives shift in favor of sabotage.¹⁰⁴

These papers point out another distinction between today and the predivestiture period. BOCs currently have no market share in interLATA long-distance; and, according to the Sibley/Weisman analysis, the BOCs' *immediate* incentive upon entry into this market does not involve sabotage, even if long-distance products are homogeneous, sabotage is free, costs are homogenous across firms up to the capacity constraint, and BOCs are fully integrated.¹⁰⁵ How long this happy state of affairs lasts depends on how quickly BOCs acquire market share. Experience with GTE and Southern New England Telephone (SNET) suggests that Sibley and Weisman's critical twenty-five percent level can be achieved by an Incumbent Local Exchange Carrier (ILEC) about two years after entry, but it is unclear whether this rapid growth will persist once multiple CLECs are simultaneously competing.¹⁰⁶

98. *See id.* at 87.

99. *See id.*

100. *See* David S. Sibley & Dennis L. Weisman, *Raising Rivals' Costs: The Entry of an Upstream Monopolist into Downstream Markets*, 10 INFO. ECON. & POL'Y 451 (1998).

101. *See id.*

102. *See id.*

103. *See id.*

104. *See id.* at 461.

105. *See id.* at 459.

106. *See* Testimony of Alfred E. Kahn & Timothy J. Tardiff at 63, Application of SBC

It is also unclear whether the cost of sabotage is significant enough to largely preclude it. In the sabotage models, access charges that are above access costs are the main source of tradeoff for the BOC.¹⁰⁷ Thus, such charges discourage sabotage and, without them, the only policy factors working to discourage sabotage would be the cost of carrying out sabotage and the structural separation requirements between the BOC and its long-distance subsidiary. Some argue that access charges above cost are an impediment to long-distance competition because they give BOCs a cost advantage in the long-distance market.¹⁰⁸ Although consumer welfare from long-distance sales would still be enhanced by the entry—provided there is no sabotage—in extreme cases, this might result in BOCs' interLATA entry and completely foreclose the long-distance market to other suppliers. Total welfare in the long-distance market would also certainly be higher without inflated access charges than with them and higher still with both cost-based access charges and a BOC in the market that conducts no sabotage. But the incentive for sabotage is higher in this setting and the regulatory controls on sabotage would have to be correspondingly elevated to bring this outcome to fruition. To the extent that access charges above costs discourage sabotage, such charges paradoxically encourage long-distance competition. This is not an argument for maintaining high access charges, since as with any price that differs from marginal cost, such charges create welfare losses.

Given the incentives created by the existing level of access profits, in order to prevent sabotage, regulators' and legislators' monitoring and penalty structures must be aggressive enough to make the expected penalty from sabotage severe enough to deter it. Thus, as access profits decrease, regulatory monitoring of sabotage must become more vigilant. As discussed below, some provisions of the Act and the FCC's Orders are directly intended to accomplish this goal.¹⁰⁹ However, even if these provisions are imperfect and allow some sabotage to occur, the improvement in consumer welfare from enhanced interLATA competition may more than offset the losses from sabotage and interLATA entry may still enhance consumer welfare. According to some estimates, a BOC's sabotage would need to be substantial enough to increase its rivals' costs by at least seventy-two percent before producing a negative net effect on

Comm. Inc., S.W. Bell Tel. Co., & S.W. Bell Comm. Servs., Inc. for Provision of In-region, InterLATA Servs. in Mo. (Mo. Pub. Serv. Comm'n Nov. 20, 1998) (No. TO-99-227).

107. See generally Mandy, *supra* note 62.

108. See Access Charge Reform, *First Report and Order*, 12 F.C.C.R. 15,982, para. 275, 7 Comm. Reg. (P & F) 1209 (1997) [hereinafter *Access Reform Order*].

109. See *infra* Part VI.B.

consumer welfare.¹¹⁰ This estimate suggests that monitoring and penalty structures need only be capable of detecting *substantial* sabotage in order to assure that BOCs interLATA entry is beneficial for consumers.

Two papers that address the question of whether access charges above cost are an impediment to long-distance competition are Franklin M. Fisher and Paul J. Hinton.¹¹¹ These papers study the effects of access charges *alone*, assuming no explicit BOC efforts to further raise rivals' costs.¹¹² Fisher assumes homogeneous long-distance products, constant marginal cost of long-distance production, and a fully-integrated BOC.¹¹³ He concludes that there is a potential welfare loss from interLATA entry by a BOC if the BOC is a less-efficient provider of long-distance than its rivals because access charges are indisputably above access costs.¹¹⁴ If aggregate long-distance volume is fixed, the BOC prefers to substitute its own long-distance service for its rivals' services as long as the price in the long-distance market is above the BOC's marginal cost of long-distance service plus the BOC's profit margin on access.¹¹⁵ Based on these considerations, when the BOC enters the interLATA market, the total cost of producing a given volume of long-distance services is increased because a high-cost producer has partially replaced lower-cost producers. Note, however, only profit decreases. Consumer welfare is unchanged as long as the long-distance price and, hence, volume is unchanged. The BOC entry will actually cause long-distance prices to drop, thereby expanding volume and increasing consumer welfare. The BOC must then tradeoff the lower price against the higher share of long-distance profits it receives on the units it directly sells plus the double marginalization savings from higher volumes and, based on this tradeoff, choose an appropriate scale of entry. In this case, the effect on total welfare is ambiguous since consumer welfare increases while total profit decreases. But, if the focus is on consumer welfare from long-distance consumption, then the BOC interLATA entry is clearly beneficial.¹¹⁶

Hinton further studies the Fisher proposition that the BOC interLATA

110. See MacAvoy, *supra* note 4, at 7.

111. See Franklin M. Fisher, An Analysis of Switched Access Pricing and the Telecommunications Act of 1996, (1996) (unpublished manuscript, on file with the *Federal Communications Law Journal*).

112. See *id.*

113. See *id.*

114. See Hinton, *supra* note 4, at 184.

115. See Affidavit of Paul S. Brandon & Richard L. Schmalensee at 38-41, Application by SBC Comm. Inc., S.W. Bell Tel. Co., and S.W. Bell Comm. Servs., Inc. for Provision of In-region, InterLATA Servs. in Mo. (Mo. Pub. Serv. Comm'n Nov. 20, 1998) (No. TO-99-227).

116. See *id.* at 41-43.

entry may decrease total welfare, even though consumer welfare is enhanced.¹¹⁷ They conduct numerical simulations that—for realistic ranges of parameter values—show total welfare always increases more when the BOC entry is integrated with its local service rather than performed by a separate affiliate, as required by the Act.¹¹⁸ Hence, the Fisher proposition is theoretically possible, but quite unlikely.¹¹⁹

Of course, since the possibility of raising rivals' costs beyond the access charge is not modeled in the Fisher and Hinton papers, a main motivation for a separate affiliate is not present in these models. As a result, the Hinton finding that a separate affiliate harms welfare must be viewed with some skepticism. Sibley, Weisman, and Economides extend their models to the case of a separate BOC subsidiary that provides long-distance service.¹²⁰ Sibley and Weisman find that the incentive to sabotage may disappear if a separate affiliate works as intended by completely separating the decision making of the local and long-distance parts of a BOC and preventing favorable terms on transactions between the BOC and its affiliate.¹²¹ This follows because the market share of such an affiliate may never reach the critical level at which sabotage becomes profitable. Economides's version of a separate subsidiary treats sabotage as affecting all long-distance sellers, including the BOC's affiliate.¹²² He finds that the incentive to sabotage disappears because the only gain from sabotage occurs when it is applied disproportionately to rivals, shifting more of the long-distance market to the BOC and enabling the BOC to reap more of the long-distance profit than it can get through its fixed access charge. If a BOC's interLATA service is offered through Economides's separate subsidiary that subsidiary suffers from any sabotage just like the BOC's rivals, and the effect on the parent company is lower access profits due to ubiquitously higher long-distance costs which drive down long-distance volume.

As with tying, the group of policies designed to introduce competition into the market for local exchange service reduces incentives to raise rivals' costs.¹²³ The logic for this is simply that if there are alternative sellers of local access that can be used by interexchange carriers (IXCs), then BOCs must offer a competitive, relatively unsabotaged, access

117. See Hinton, *supra* note 4, at 185-86.

118. See *id.* at 189.

119. See *id.*

120. See Sibley & Weisman, *supra* note 100; Economides, *supra* note 76.

121. See Sibley & Weisman, *supra* note 100, at 464.

122. See Economides, *supra* note 76, at 281.

123. See Beard, *supra* note 55, at 22-23.

product or risk losing their access customers. Competitive Access Providers (CAPs) are an example of this outcome. Competition for local exchange service may only shift the motives for sabotage from IXCs to CLECs. As mentioned above, the incentives for this type of sabotage are not well understood because the existing literature does not address this case very explicitly. To the extent there are incentives for this type of sabotage, however, the solution remains to make sabotage costly through regulatory oversight.

C. Creating Incentives to Reduce Entry Barriers into the Local Exchange Business

The third and last economic argument against BOCs' entry into long-distance is that the "carrot" of permitting BOCs to serve interLATA markets must be held out to provide incentives for BOCs to reduce barriers to entry into the local exchange business. Such barriers may be either natural or intentionally erected by BOCs; but in either case, BOCs are viewed as possessing unique abilities to reduce them. As mentioned above, Beard, Kaserman, and Mayo find that more intense competition in the local exchange market can eliminate incentives for sabotage.¹²⁴ As already noted, enhanced competition for local exchange service may also reduce undesirable motives for tying. Consequently, there are direct reasons to link interLATA entry to the presence of local competition. Paradoxically, the incentives are bidirectional—tying and sabotage should both encourage local competition as IXCs seek ways to circumvent any such BOC behavior.

On the other hand, holding out this carrot carries a cost in the form of delayed interLATA competition. An indication of the potential magnitude of lost welfare is given by the Hinton and MacAvoy estimates. These opportunity costs from delayed long-distance competition continue as long as the delay continues.¹²⁵ Jerry A. Hausman presents a variety of opportunity cost estimates from past regulatory delays in allowing new entry and finds that the welfare losses can be very large.¹²⁶ He argues that these same considerations apply to BOCs' interLATA entry, making it unwise to continue to block such entry.¹²⁷ Some argue that IXCs are delaying their entry into local markets in order to prevent BOCs from

124. *See id.*

125. *See* Hinton, *supra* note 4, at 189; MacAvoy, *supra* note 4, at 6.

126. *See* Jerry A. Hausman, *Valuing the Effect of Regulation on New Services in Telecommunications*, in *BROOKINGS PAPERS ON ECONOMIC ACTIVITY (MICROECONOMICS)* 1-38 (Martin Neil Bailey et al. eds., 1997).

127. *See id.*

meeting either the Track A or Track B requirements.¹²⁸ If this is true, further opportunity costs occur as a result of linking interLATA entry to local competition. Even if this strategic delay is occurring, its further costs in local exchange markets may be small because the main immediate benefit associated with enhanced competition is lower prices, and the potential for this is limited in at least some parts of local exchange markets by existing price cap regulation. Of course, if price cap regulation were bringing all the benefits of competition to the local exchange, there would be no reason to encourage competition. To the extent that local exchange competition is beneficial, any strategic delay that is occurring must be creating opportunity costs that are attributable to the policy linking long-distance competition to local competition. The Beard result confirms that price cap regulation does not in fact bring all the benefits of competition to the local exchange market because the regulation does not eliminate incentives for sabotage.¹²⁹

Aside from these arguments for and against the policy of inducing BOCs to reduce entry barriers by holding out the promise of interLATA entry, creating incentives for local exchange competition is valuable for the same basic reason that allowing BOCs entry into interLATA markets is valuable: Free and open competition brings about the lowest possible prices and the mix of services that is most closely aligned with consumers' preferences. In the case of local competition, there is the nagging doubt that free and open competition may not be efficient because the market might still be a natural monopoly—served at least cost by only one supplier.¹³⁰ However, the Act's requirements concerning unbundling and resale recognize this possibility by creating wholesale markets for telecommunications services so that robust competition can exist at the retail level even if there is little competition at the facilities level. But in this case, facilities-based competition will not be widespread. This possibility diminishes the incentives for reducing entry barriers in markets for local exchange service, at least partly because of the FCC's interpretation of Track B, which is addressed in the next part.

III. CONTENTIOUS ISSUES IN THE SECTION 271 ORDERS

This part discusses six issues that have been prominent in the FCC's

128. See Duane Ackerman, *Why Is AT&T Afraid to Compete?*, WALL ST. J., July 3, 1997, at A10.

129. See Beard, *supra* note 55, at 22-23.

130. This is not well established and is independent of the fact that BOCs are no longer franchise monopolies. Natural monopoly is defined by cost relative to demand, not by the presence or absence of a legal franchise.

six extant Orders concerning interLATA entry and in other policy arenas. The first is the interpretation of the Track A and B requirements. The second is access to the Unbundled Network Element (UNE) known as Operational Support Systems (OSS). The third is interconnection, while the fourth is access to the local transport and local switching UNEs, and the CLEC's ability to combine UNEs. The fifth is the FCC's pricing rules, while the last is the FCC's pick and choose rule.

A. *Track A and B Requirements*

Section 271(c)(1)(A) of the Act provides that a BOC meets the first condition for interLATA entry

[I]f it has entered into one or more binding agreements . . . specifying the terms and conditions under which the [BOC] is providing access and interconnection . . . for . . . one or more unaffiliated competing providers of telephone exchange service . . . to residential and business subscribers. [S]uch telephone exchange service may be offered by such competing providers either exclusively over their own . . . facilities or predominantly over their own . . . facilities in combination with . . . resale¹³¹

Alternatively, section 271(c)(1)(B) provides that a BOC also meets the first condition for interLATA entry if

[N]o such provider has requested the access and interconnection described in subparagraph (A) . . . and a statement of the terms and conditions that the [Bell operating] company generally offers to provide such access and interconnection has been approved or permitted to take effect by the State commission¹³²

These are the only requirements that the FCC ruled on in the 1997 *Order* affecting SBC Communications, Inc.'s application in Oklahoma (*Oklahoma Order*).¹³³ Most of the *Oklahoma Order* is devoted to determining whether these requirements are met.¹³⁴ Ultimately, the FCC determined that Brooks Fiber was not a "competing provider" because, even though Brooks and Southwestern Bell had entered into an agreement specifying terms and conditions for access and interconnection of both residential and business subscribers, Brooks was not at that time actually selling services to residential subscribers.¹³⁵ The FCC adopted the interpretation that, to be a "competing provider," a company must be "an

131. 47 U.S.C. § 271 (c)(1)(A) (Supp. II 1996).

132. *Id.* § 271(c)(1)(B) (Supp. II 1996).

133. *See Oklahoma Order*, 12 F.C.C.R. 8685, para. 1, 8 Comm. Reg. (P & F) 198 (1997).

134. *See id.*

135. *See id.* at para. 17.

actual commercial alternative” to the BOC.¹³⁶ In this interpretation, “competing” is the operative word. The FCC decided that a company could not be competing unless it was actually offering its services for sale.¹³⁷ The same type of active interpretation could be placed on the phrase “is providing,” although the FCC did not do so. It could be argued that a BOC is providing access and interconnection only if the CLEC is actually buying and using the BOC’s access and interconnection services. If Congress meant otherwise, the wording would be “has agreed to provide.” Given the consistent use of active wording in the Track A subparagraph, the FCC’s interpretation seems consistent with the Act.

The FCC then decided that a “qualifying request” for Track B *had* occurred because, even though no provider was actually selling residential local exchange service at that time, requests for access and interconnection had been made that would satisfy Track A *if implemented*.¹³⁸ Much discussion is devoted to supporting this interpretation of Track B, since this interpretation means that the reference “such provider” can be to either an actual or potential competitor, in contrast to the interpretation of Track A—that the provider must be “an actual commercial alternative.”¹³⁹ The FCC argues that its double meaning of provider is necessary for Track B to make sense because, to be an actual commercial alternative, a CLEC must have already requested access and interconnection. In other words, no provider that is an actual commercial alternative can request access and interconnection. Hence, if such provider in Track B is the competing provider of Track A, then it would be impossible for a request to ever be received from such provider.¹⁴⁰ Other justifications offered by the FCC (such as the strict requirement that a provider in subparagraph B be the actual commercial alternative of subparagraph A) would create incentives for BOCs to delay interconnection agreements and would read some exceptions mentioned later in subparagraph B out of the statute.¹⁴¹

This interpretation of the Track A and B requirements was the sole factor in the FCC’s *Order* denying Southwestern Bell’s application. The FCC failed to address many items of interest, including: (1) whether Brooks was at least a competing provider to business subscribers; (2) what constitutes predominantly facilities-based; (3) whether the predominantly facilities-based standard applies separately to residential and business

136. *Id.* at para. 14.

137. *See id.* at para. 17.

138. *See id.* at para. 27.

139. *Id.* at para. 14.

140. *See id.* at paras. 33-53.

141. *See id.* at para. 29.

subscribers or only in the aggregate; (4) whether the requirement that CLEC service be offered to both residential and business subscribers applies to individual CLECs or only in the aggregate; and (5) whether there are minimal levels of geographic and market share penetration that must be achieved before a CLEC is an actual commercial alternative. Moreover, the FCC made no evaluation of whether Southwestern Bell met the checklist, separate affiliate, and public interest requirements.

Following denial of the application, SBC contested the *Oklahoma Order*.¹⁴² SBC argued that the FCC effectively closed Track B through its interpretation of the Act.¹⁴³ The FCC defended its position by arguing that the statute's omission of the word "competing" between "such" and "provider" differentiated the requirements of Track A from those of Track B.¹⁴⁴ The court ruled that "it is not apparent on their face whether 'such provider' in Track B is intended to mean a carrier who has met the requirements of Track A."¹⁴⁵ Due to this ambiguity in the wording of the legislation, the court upheld the FCC's *Order* by following the standards set in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*¹⁴⁶ The ruling concluded by stating that Congress "clearly gave the [FCC] the primary responsibility to make delicate judgments" similar to those in question.¹⁴⁷ Therefore, the FCC should be free to perform that task as long as it acts in good faith.

Bearing this in mind, the FCC's Track B interpretation still presents some difficulties in that it requires a judgment on whether implementation of agreements is proceeding.¹⁴⁸ Otherwise, a CLEC could foreclose BOC interLATA entry by simply not becoming a predominantly facilities-based actual commercial alternative for both residential and business subscribers, but *potentially* being such a provider by virtue of an agreement specifying interconnection terms for such services. There is an exception in subparagraph B specifying that no request has been received from a CLEC if the state commission determines the CLEC failed to meet an implementation schedule contained in its agreement with the BOC.¹⁴⁹ This seems to indicate that judgments about implementation are up to state

142. *See SBC Comm., Inc. v. FCC*, 138 F.3d 410 (D.C. Cir. 1998).

143. *See id.* at 417.

144. *See id.* at 416.

145. *Id.* at 418.

146. 467 U.S. 837 (1984) (requiring the court to defer to the FCC's interpretation of the ambiguous test as long as it is a permissible reading).

147. *SBC Comm., Inc.*, 138 F.3d at 421.

148. *See Oklahoma Order*, 12 F.C.C.R. 8685, para. 58, 8 Comm. Reg. (P & F) 198 (1997).

149. *See* 47 U.S.C. § 271(c)(1)(B)(ii) (Supp. II 1996).

commissions. This does not, however, address cases in which an agreement does not contain an implementation schedule, even though many agreements do not. Recognizing this, the FCC adopted a “reasonable steps” criterion—not contained in the Act—to judge implementation made necessary by its interpretation of Track B. However, in its first *Order*, the new commission under Chairman Kennard backed away from the reasonable steps criterion.¹⁵⁰

Specifically, in the *Order* addressing BellSouth’s application in South Carolina (*South Carolina Order*), the FCC emphasized reasonable steps between an initial and subsequent reapplication in a particular state, suggesting that a BOC may not be able to argue that an *initial* application qualifies under Track B on the basis that reasonable steps toward implementation have not occurred.¹⁵¹ The FCC also opined in the *South Carolina Order* that it may be more efficient to seek state commission certification that CLECs have not met implementation schedules than to judge whether reasonable steps have been taken toward implementation.¹⁵² Hence, the FCC’s interpretation of Track B and the reasonable steps criterion places great importance on implementation schedules, making such schedules the weapon available to BOCs to avoid being foreclosed from interLATA entry.¹⁵³ Unfortunately, neither BOCs nor state commissions anticipated the importance of the schedules. In fact, many agreements, including some that were arbitrated, simply do not contain implementation schedules even though the Act specifically requires that arbitrated agreements contain such schedules.¹⁵⁴

In Ameritech’s application in Michigan (*Michigan Order*), the FCC addressed some of the questions surrounding Track A compliance that it had left unanswered in the *Oklahoma Order*.¹⁵⁵ In particular, the FCC determined that: (1) Brooks, MFS, and TCG are all competing providers in the sense that they are actual commercial alternatives to the BOC; (2) Brooks is exclusively facilities-based because it uses only its own equipment and Ameritech’s UNEs, which the FCC determined were a CLEC’s own facilities for purposes of Track A compliance; (3) the requirement that CLEC service be offered to both residential and business subscribers applies in the aggregate; (4) there is no minimal level of

150. See *Oklahoma Order*, 12 F.C.C.R. 8685, para. 58, 8 Comm. Reg. (P & F) 198.

151. See *South Carolina Order*, 13 F.C.C.R. 539, para. 61, 10 Comm. Reg. (P & F) 870 (1998).

152. See *id.* at para. 64.

153. See *id.*

154. See *id.* at para. 64 (The South Carolina commission arbitrated this, but it does not contain an implementation schedule); 47 U.S.C. §252(c)(3) (Supp. II 1996).

155. See *Michigan Order*, 12 F.C.C.R. 20,543, 9 Comm. Reg. (P & F) 267 (1997).

geographic penetration that must be achieved before a CLEC is an actual commercial alternative; (5) there is no minimal market share that must be achieved before a CLEC is an actual commercial alternative, but a de minimis number of access lines, as possessed by Brooks, MFS, and TCG, is required; and (6) every checklist item need not be in every interconnection agreement, and BOCs need not be actually furnishing every checklist item in order to satisfy the competitive checklist.¹⁵⁶ The finding on market share is inconclusive, since no specific meaning of de minimis has been given for this context. The finding on checklist items is consistent with a reading of the Act that carefully interprets the requirement that BOCs either “fully implement” the checklist *or* “offer” every checklist item through an SGAT. Otherwise, the application may be inconsistent with section 271(d)(3)(A), which contains the “fully implement” or “offer” language.¹⁵⁷ Finally, because the FCC determined that Brooks was exclusively facilities-based in Michigan, the FCC neither provided a definition of “predominantly” nor determined whether it applies to business and residential services separately. In finding that Bell Atlantic satisfied the Track A requirements in New York, the FCC ruled “that AT&T, MCI WorldCom, and Cablevision Lightpath provide telephone exchange service either exclusively or predominantly over their own facilities to residential and to business subscribers.”¹⁵⁸ However, the agency still neither defined “predominantly” nor evaluated whether it applies to business and residential services separately.”

The FCC’s interpretation of Track B has the potential to slow the introduction of competition into both the local exchange and interLATA markets. Since the FCC based all other denials, at least in part, on checklist noncompliance, to date, this interpretation has only explicitly resulted in a denial in Oklahoma. There may be implicit effects on both BOC and CLEC strategies toward the local exchange and interLATA markets that are ultimately more important than any explicit effects. Moreover, given the checklist issues that have arisen in other states, it seems likely that the Oklahoma application would not have passed a serious review of checklist compliance. Consider the situation in which a BOC has satisfied the checklist and structural requirements. Under the FCC’s interpretation, even though all of the market-opening directives that the Act imposes on the BOC have been accomplished, interLATA entry still cannot be granted

156. *See id.* at paras. 76-78, 82, 101-102. Congress considered, and explicitly rejected, the use of a market share test for determining whether local exchange markets are open. Whether the de minimis standard for an “actual commercial alternative” is consistent with this legislative history is an open question. *Id.* at para. 27.

157. 47 U.S.C. § 271(d)(3)(A) (Supp. II 1996).

158. *New York Order*, FCC 99-404, 1999 WL 1243135, para. 62 (Dec. 22, 1999).

unless either: (1) there are CLECs that have binding access and interconnection agreements with the BOC, which need not include implementation schedules for the CLECs; are actual commercial alternatives to the BOC, meaning that the CLECs need not be everywhere in the state but that they must have a vague de minimis number of access lines; are collectively serving both residential and business subscribers; and are predominantly facility—or UNE-based, where “predominantly” has yet to be defined in terms of either its separate or joint application to residential and business customers, or its aggregate meaning; or (2) every CLEC that has requested access or interconnection can be placed into one of two groups—those who have violated an implementation schedule or have negotiated in bad faith, as certified by the state commission or those for whom the BOC can demonstrate that the requested access and interconnection, when implemented, will not satisfy item one.

If the BOC cannot establish item one as a general matter, then interLATA entry *cannot be granted* if there is *even one* CLEC for whom the BOC is unable to persuade the state commission of an implementation or negotiation violation, or for whom the BOC is unable to persuade the FCC that the requested access and interconnection will ultimately fail to satisfy item one. This is unrealistic. In South Carolina, it means BellSouth needed either a failed negotiation/implementation certification from the South Carolina Commission, or a preponderance of evidence before the FCC that an agreement would not satisfy Track A even if implemented, *for each of eighty-three separate CLECs.*¹⁵⁹

Given the hopelessness of this task, it is an open question whether BOCs feel a real incentive to reduce entry barriers in local exchange markets. The only actions that seem clearly destined to move BOCs closer to interLATA entry are those that help satisfy item one as a general matter. Those same actions subject BOCs to competition from CLECs that may not satisfy item one if, for example, CLECs serve only high-profit business subscribers, serve residential subscribers only through resale, or maintain a low enough facilities/UNE presence that the predominant standard is not met. In principle, the BOC recourse in such circumstances is to pursue item two. This would be an exceptionally lengthy and contentious process and would be doomed to fail if there was even one CLEC for whom no firm implementation schedule was negotiated or who had just recently made a broad request for access and interconnection but for whom insufficient time had passed to address whether implementation was proceeding as promised.

159. See *South Carolina Order*, 13 F.C.C.R. 539, para. 65, 10 Comm. Reg. (P & F) 870.

It is not clear that the lengthy approach outlined in item two is necessary for a Track B application according to the Act because the exceptions contained in section 271(c)(1)(B) are never described in the statute as the *only* mechanisms for Track B. The FCC characterizes them in the *Michigan Order* as the only available avenue for Track B compliance.¹⁶⁰ As in Oklahoma, failure to meet the Track B requirements was one of the reasons for the FCC denial in South Carolina (Track A requirements also were not met for essentially the same reasons given in the *Oklahoma Order*).¹⁶¹ Notably, neither BellSouth in Louisiana nor Bell Atlantic in New York pursued Track B in its reapplication.¹⁶²

B. Access to OSS

In the *Michigan Order*, *South Carolina Order*, *Louisiana Order*, BellSouth's second application attempt in Louisiana (*Louisiana II Order*), and the *New York Order*, the FCC evaluated compliance with certain checklist items, even though this was not strictly necessary in South Carolina since a determination was made that neither Track A nor Track B were met.¹⁶³ Checklist item (ii) requires "Nondiscriminatory access to network elements in accordance with the requirements of sections 251(c)(3) and 252(d)(1)," and the Act requires for approval an FCC finding that the checklist has either been "fully implemented" through interconnection agreements or "fully offered" through a SGAT.¹⁶⁴ The FCC's 1996 *Order* addressing the implementation of local competition provisions (*Local Competition Order*), in turn, defined OSS as a UNE,¹⁶⁵ thereby requiring that BOCs provide OSS access in accordance with checklist item (ii). This part of the *Local Competition Order* was upheld by the Eighth Circuit in *Iowa Utilities Board v. FCC*, but was subsequently vacated by the Supreme Court, which ruled that the FCC had not given

160. See *Michigan Order*, 12 F.C.C.R. 20,543, para. 112, 9 Comm. Reg. (P & F) 267.

161. See *Oklahoma Order*, 12 F.C.C.R. 8685, para. 20, 8 Comm. Reg. (P & F) 198 (1997).

162. See *New York Order*, FCC 99-404, 1999 WL 1243135, para. 62; *Louisiana II Order*, 13 F.C.C.R. 20,599, 13 Comm. Reg. (P & F) 1082 (1998).

163. See *New York Order*, FCC 99-404, 1999 WL 1243135, para. 62; *Louisiana II Order*, 13 F.C.C.R. 20,599, 13 Comm. Reg. (P & F) 1082; *Michigan Order*, 12 F.C.C.R. 20,543, 9 Comm. Reg. (P & F) 267; *South Carolina Order*, 13 F.C.C.R. 539, para. 65, 10 Comm. Reg. (P & F) 870; *Louisiana Order*, 13 F.C.C.R. 6245, 11 Comm. Reg. (P & F) 328 (1998).

164. 47 U.S.C. § 271(c)(2)(B) (Supp. II 1996) (referencing checklist items); see *id.* § 271(d)(3)(A) (Supp. II 1996).

165. See Implementation of Local Competition Provisions of the Telecomms. Act of 1996, *First Report and Order*, 11 F.C.C.R. 15,499, para. 526, 4 Comm. Reg. (P & F) 1 (1996) [hereinafter *Local Competition Order*]; 47 C.F.R. § 51.319 (1998).

substance to the statutory requirements that the agency consider whether access to a UNE that is *proprietary* is *necessary* and whether lack of access would *impair* CLECs.¹⁶⁶ The FCC's position that OSS is indeed a UNE that meets the Act's "necessary" and "impairment" standards was subsequently restated in the *UNE Order*.¹⁶⁷ The FCC has defined OSS as the various systems used for "pre-ordering [sic], ordering, provisioning, maintenance and repair, and billing of [UNEs] and resold services."¹⁶⁸

In all three states the BOC made certain computer systems available to CLECs. However, these systems typically required that customer information keyed in as part of a customer inquiry (i.e., preordering) be rekeyed to place an actual order. This could lead to transcription errors, extra personnel time, and phone numbers or dates for service activation being different from what a CLEC told its customer during their initial inquiry. Moreover, the systems did not always relay problems with an order back to the CLEC as quickly as similar problems would be identified for the BOC. In fact, in some cases, they relied on manual handling and faxing of documents. In contrast, most of these activities are supported with a seamless electronic system for BOCs' own customers.

Similarly, the FCC argued that the OSS made available for ordering UNEs, maintenance and repair functions, and billing were inadequate or their adequacy was insufficiently documented.¹⁶⁹ As discussed in Part III.D, BellSouth did not provide a method for ordering combinations of UNEs and did not document that the level of manual intervention was appropriate.¹⁷⁰ BellSouth only offered manual ordering methods for complicated orders.¹⁷¹ Likewise, certain maintenance and repair problems could not be handled electronically in Louisiana, and some usage measurement data that are needed for customer billing were not being provided to CLECs.¹⁷²

The FCC concluded that this constitutes discriminatory access to the

166. See 47 U.S.C. § 251(d) (Supp. II 1996); *Iowa Utils. Bd. v. FCC*, 120 F.3d 753 (8th Cir. 1997), *aff'd in part and rev'd in part*, 525 U.S. 366 (1999); *AT&T Corp. v. Iowa Utils. Bd.*, 119 S. Ct. 1022 (1999) (vacating "Rule 319" of 47 U.S.C. § 52 because the FCC failed to adequately interpret the Act's "necessary" and "impairment" standards); see also *infra* Part III.D.

167. See Implementation of the Local Competition Provisions of the Telecomms. Act of 1996, *Third Report and Order and Fourth Further Notice of Proposed Rulemaking*, FCC 99-238, 1999 WL 1008985, paras. 424, 433 (1999) [hereinafter *UNE Order*].

168. *Local Competition Order*, 11 F.C.C.R. 15,499, para. 525, 4 Comm. Reg. (P & F) 1.

169. See *Louisiana II Order*, 13 F.C.C.R. 20,599, paras. 136-44, 149, 154-55, 157, 160, 13 Comm. Reg. (P & F) 1082 (1998).

170. See *id.* at paras. 138, 141.

171. See *id.*

172. See *id.* at paras. 149-57, 159-60.

OSS UNE and used this as a basis for denial in all four Orders.¹⁷³ Although both Ameritech and BellSouth argued that their systems provide access to basic OSS functionality, neither was able to establish that the access was truly nondiscriminatory. Hence, the FCC decision appears consistent with the Act and also with the objective of reducing barriers to entry into the local exchange market.

The importance attached to OSS is clearly displayed in the *New York Order*, where the FCC devotes 88 of 226 pages to an extremely detailed analysis of whether Bell Atlantic's OSS meets the statutory requirements.¹⁷⁴ Overall, the FCC found that Bell Atlantic met the statutory requirement for OSS because of its service delivery evidenced by numerous performance measures, the involvement of the New York Public Service Commission, and the independent third party review of KPMG.¹⁷⁵ In particular, the FCC describes the tests performed by KPMG as "broad in scope," "independent and blind, and "persuasive evidence."¹⁷⁶

C. Interconnection

Checklist item (i) requires "[i]nterconnection in accordance with the requirements of sections 251(c)(2) and 252(d)(1)," and section 251(c)(2) of the Act requires interconnection "that is at least equal in quality to that provided by the local exchange carrier to itself."¹⁷⁷ In the *Michigan Order*, the FCC discusses an interconnection dispute between Ameritech and its rivals over "trunk blocking," which is essentially the failure to carry a signal over a trunk between end offices and/or tandem switches.¹⁷⁸ The allegation is that the percentage of calls that Ameritech's trunks failed to carry was higher for rivals than for Ameritech.¹⁷⁹ Ameritech disputed this and offered explanations, but ultimately the FCC decided that interconnection could not be equal in quality if trunk blocking rates were substantially different and used this as a basis for denial in Michigan.¹⁸⁰ This is a sensible interpretation that seems consistent with the Act and with

173. See *Louisiana Order*, 13 F.C.C.R. 6245, para. 22, 11 Comm. Reg. (P & F) 328 (1998); *Louisiana II Order*, 13 F.C.C.R. 20,599, para. 91, 13 Comm. Reg. (P & F) 1082; *Michigan Order*, 12 F.C.C.R. 20,543, para. 204, 9 Comm. Reg. (P & F) 267 (1997); *South Carolina Order*, 13 F.C.C.R. 539, para. 87, 10 Comm. Reg. (P & F) 870 (1998).

174. See *New York Order*, FCC 99-404, 1999 WL 1243135, paras. 82-228 (Dec. 22, 1999).

175. See *id.*

176. See *id.* at paras. 97, 99-100.

177. 47 U.S.C. § 251(c)(2) (Supp. II 1996).

178. See *Michigan Order*, 12 F.C.C.R. 20,543, paras. 222-55, 9 Comm. Reg. (P & F) 267.

179. See *id.* at para. 240.

180. See *id.* at para. 224.

reducing entry barriers, since trunk blocking can result in customers' calls not getting through, which is a direct indicator of quality to consumers.

In Louisiana, the FCC found that BellSouth had committed to a binding obligation to provide trunks equal in quality, but that comparative data on actual blocking rates suggested BellSouth was not fulfilling this obligation.¹⁸¹ As discussed below, BellSouth's collocation arrangements were problematic as well because the Louisiana SGAT did not bind BellSouth to specific installation intervals for interconnection of collocated equipment and did not state all relevant prices, although some progress on the reporting of installation intervals occurred between the *Louisiana* and *Louisiana II* applications.¹⁸²

Chairman Kennard's letter on interconnection (*FCC Summary*) issued in response to Senators John McCain and Sam Brownback reiterates that "the equal in quality obligation . . . includes . . . quality as perceived by the requesting telecommunications carrier."¹⁸³ Arguably, this is a stronger interpretation than the requirement in the *Michigan Order* of equal trunk blocking rates because it allows CLECs to define what constitutes equal quality rather than simply requiring that the BOC provide "interconnection equivalent to the interconnection it provides itself."¹⁸⁴ Conversely, requiring equal quality only at the consumer level could create a situation in which the interconnection is awkward and costly for the CLEC even though these problems are unobservable to consumers. Rather than addressing this possibility through the equal in quality requirement, it might be preferable to rely on section 251(c)(2) of the Act, which requires that interconnection be provided "on rates, terms, and conditions that are just, reasonable, and nondiscriminatory."¹⁸⁵ This would avoid giving undue weight to either consumers' or CLECs' definition of "equal quality."

In the *New York Order*, the FCC found that Bell Atlantic's interconnection satisfied the statutory requirements precisely because Bell Atlantic's performance measures, agreements, and collocation offerings demonstrated that Bell Atlantic had overcome the problems encountered in Michigan and Louisiana.¹⁸⁶ In particular, the FCC carefully evaluated

181. See *Louisiana II Order*, 13 F.C.C.R. 20,599, para. 77, 13 Comm. Reg. (P & F) 1082.

182. See *id.* at paras. 65, 72-73, 77.

183. Letter from William Kennard, Chairman, FCC, to John McCain & Sam Brownback, U.S. Senators attachment i-2 (July 16, 1998) [hereinafter *FCC Summary*] (on file with the *Federal Communications Law Journal*).

184. *Michigan Order*, 12 F.C.C.R. 20,543, para. 243, 9 Comm. Reg. (P & F) 267.

185. 47 U.S.C. § 251(c)(2) (Supp. II 1996).

186. See *New York Order*, FCC 99-404, 1999 WL 1243135, paras. 63-78 (Dec. 22, 1999).

whether Bell Atlantic was providing equal-in-quality interconnection that meets the same technical standards as its own trunking and that is available at any technically feasible point.¹⁸⁷

*D. Unbundled Local Transport and Local Switching:
Combinations of UNEs*

Although not used as a basis for denial, the FCC expressed concern in the *Michigan Order* over checklist item (v), which requires BOCs' provision of "[l]ocal transport from the trunk side of a wireline local exchange carrier switch unbundled from switching or other services," and checklist item (vi), which requires BOC provision of "[l]ocal switching unbundled from transport, local loop transmission, or other services."¹⁸⁸

Dedicated local transport has been relatively uncontroversial. Rather, most of the debate has centered on shared local transport. The FCC defined "shared local transport" as a UNE in the part of the *Local Competition Order* not vacated by the Eighth Circuit. The FCC reaffirmed its status as a UNE following the Supreme Court decision to vacate rule 319.¹⁸⁹ There is no debate over whether Ameritech refused to share local transport as a UNE with CLECs. Ameritech's shared local transport offerings allowed CLECs to share a trunk or part of a trunk with each other, but otherwise treated shared local transport as a resale item. That is, there was no provision for a CLEC to share a trunk with Ameritech as a UNE.¹⁹⁰ Hence, the only possible debate in the Michigan proceeding concerned whether the shared local transport identified in the *Local Competition Order* included sharing with the BOC, or whether the BOC could merely arrange for CLECs to share with each other. The FCC's final rules required the BOC to "[p]rovide . . . use of the features, functions, and capabilities of interoffice transmission facilities shared by more than one customer or carrier,"¹⁹¹ which included no exception for sharing with the BOC.

Sharing of trunks at very disaggregated levels certainly provides more flexibility to the CLEC and thereby reduces entry barriers. According to

187. *See id.* at paras. 67.

188. *Michigan Order*, 12 F.C.C.R. 20,543, paras. 298, 319, 9 Comm. Reg. (P & F) 267 (footnotes omitted).

189. *See Iowa Utils. Bd. v. FCC*, 120 F.3d 753 (8th Cir. 1997), *aff'd in part and rev'd in part*, 525 U.S. 366 (1999); *AT&T Corp. v. Iowa Utils. Bd.*, 119 S. Ct. 1022 (1999) (vacating "Rule 319" of 47 U.S.C. § 52 because the FCC failed to adequately interpret the Act's "necessary" and "impairment" standards); *see also infra* Part III.D.; *see also UNE Order*, FCC 99-238, 1999 WL 1008985, paras. 321, 369 (1999).

190. *See Michigan Order*, 12 F.C.C.R. 20,543, paras. 311-18, 9 Comm. Reg. (P & F) 267.

191. 47 C.F.R. § 51.319(d)(2)(i) (1998).

section 252(d)(2), in deciding which elements must be unbundled, the Act only requires that the FCC consider “whether access to such network elements as are proprietary in nature is necessary; and [whether] the failure to provide access to such network elements would impair the ability of the telecommunications carrier seeking access to provide the services that it seeks to offer.”¹⁹² In the *Local Competition Order*, the FCC interpreted the necessary and impairment standards broadly.¹⁹³ Although the Eighth Circuit upheld this interpretation,¹⁹⁴ the Supreme Court determined that “the Act requires the FCC to apply *some* limiting standard, rationally related to the goals of the Act, which it has simply failed to do.”¹⁹⁵ This was the basis for the Court’s decision to vacate rule 319. A new set of unbundling requirements that interprets the necessary and impairment standards resulted in continuing requirements that BOCs share local transport.¹⁹⁶ Rather than contesting the necessity of shared local transport or the lack of impairment in refusing to share local transport, however, Ameritech argued that local transport shared with the BOC could not be regarded as a UNE because it is not a physically distinct element. The FCC rejected this argument in the *Michigan Order*, and simultaneously issued a third order on the implementation of local competition provisions (*Third Reconsideration Order*), which unequivocally states the agency’s position that “[t]he term ‘carrier’ includes both an incumbent LEC as well as a requesting telecommunications carrier. We, therefore, conclude that ‘shared transport,’ as required by the *Local Competition Order* encompasses a facility that is shared by multiple carriers, including the incumbent LEC.”¹⁹⁷ The Supreme Court also rejected the assertion that a UNE must be physically distinct, concluding that “it is impossible to credit the incumbents’ argument that a ‘network element’ must be part of the physical facilities and equipment used to provide local phone service.”¹⁹⁸ Despite this, Ameritech continued to argue in the *UNE Order* that shared transport is not a UNE because it cannot be utilized without local switching.¹⁹⁹ As before, the FCC rejected this argument.²⁰⁰

192. 47 U.S.C. § 251 (d)(2) (Supp. II 1996).

193. See *Local Competition Order*, 11 F.C.C.R. 15,499, para. 282-85, 4 Comm. Reg. (P & F) 1 (1996).

194. See *Iowa Utils. Bd.*, 120 F.3d at 810.

195. *AT&T Corp. v. Iowa Utils. Bd.*, 119 S. Ct. 721, 734-35 (1999) (emphasis added).

196. See *UNE Order*, FCC 99-238, 1999 WL 1008985, paras. 321, 369 (1999).

197. Implementation of the Local Competition Provisions of the Telecomms. Act of 1996, *Third Order on Reconsideration and Further Notice of Proposed Rulemaking*, 12 F.C.C.R. 12,460, para. 22, 8 Comm. Reg. (P & F) 1206 (1997) [hereinafter *Third Reconsideration Order*].

198. *AT&T Corp.*, 119 S. Ct. at 734.

199. See *UNE Order*, FCC 99-238, 1999 WL 1008985, para. 371.

Several concerns were expressed over Ameritech's local switching. The first was Ameritech's requirement that a CLEC purchase an entire trunk-side port with the local switching UNE, rather than allowing only the part of a shared trunk-side port that the CLEC needs to be purchased as a separate UNE.²⁰¹ In the part of the *Local Competition Order* not vacated by the Eighth Circuit but ultimately vacated by the Supreme Court, the FCC defined trunk-side ports as a UNE.²⁰² Hence, this issue is the same as the local transport issue: At what level of disaggregation must BOCs make their trunk ports and trunks available as UNEs? Although trunk ports are not specifically discussed in the *Third Reconsideration Order*, the basic thrust seems clear. The July 1998 *FCC Summary* on unbundled local switching requires BOCs to provide "trunk ports on a shared basis . . . as necessary to provide nondiscriminatory access to shared transport facilities."²⁰³ It only makes sense to share local transport if the port connecting that local transport to the switch is shared as well. The FCC ultimately made this logic plain in the *UNE Order*, stating that the "lack of unbundled access to incumbent's shared transport would impair the requesting carrier's ability to use *unbundled switching*."²⁰⁴ Some of this disagreement between the FCC and Ameritech can be explained by the fact that the FCC released the *Michigan Order* and the *Third Reconsideration Order* almost simultaneously.²⁰⁵ However, referring to the *Local Competition Order*, the FCC is persuasive in pointing out that "a fair reading of our [*Order*] and rules does not support the claim advanced by Ameritech that a shared network element necessarily is shared only among competitive carriers and is separate from the facility used by the incumbent LEC for its own traffic."²⁰⁶ The Supreme Court trumped this entire debate by vacating rule 319 in *AT&T Corp. v. Iowa Utilities Board*, and the debate

200. *See id.* at para. 372.

201. *See Michigan Order*, 12 F.C.C.R. 20,543, para. 324, 9 Comm. Reg. (P & F) 267 (1997).

202. *See* Implementation of Local Competition Provisions of the Telecomms. Act of 1996, *First Report and Order*, 11 F.C.C.R. 15,499, para. 526, 4 Comm. Reg. (P & F) 1 (1996) [hereinafter *Local Competition Order*]; 47 C.F.R. §51.319 (1998); *Iowa Utils. Bd. v. FCC*, 120 F.3d 753 (8th Cir. 1997), *aff'd in part and rev'd in part*, 525 U.S. 366 (1999); *AT&T Corp. v. Iowa Utils. Bd.*, 119 S. Ct. 1022 (1999) (vacating "Rule 319" of 47 U.S.C. § 52 because the FCC failed to adequately interpret the Act's "necessary" and "impairment" standards); *see also infra* Part III.D.

203. *FCC Summary*, *supra* 183, at attachment vi-2.

204. *See UNE Order*, FCC 99-238, 1999 WL 1008985, para. 369 (1999) (footnote omitted) (emphasis added).

205. The FCC released the *Third Reconsideration Order* on August 18, 1997 followed by the *Michigan Order* on August 19, 1997.

206. *Third Reconsideration Order*, 12 F.C.C.R. 12,460, para. 22, 8 Comm. Reg. (P & F) 1206 (1997).

is now at least temporarily resolved by the *UNE Order*.²⁰⁷

A second concern expressed over local switching was Ameritech's refusal to supply all of the features of the switch as part of the switching UNE, and particularly, Ameritech's failure to provide the routing table (the information on which long-distance route is used for long-distance calls that originate on a particular loop).²⁰⁸ The FCC's concern here is consistent with the concept of reducing entry barriers and was reiterated in the *Third Reconsideration Order*, where the agency "conclude[d] that the *Local Competition Order* was not ambiguous as to an incumbent LEC's obligation to offer access to the routing table resident in the local switch to requesting carriers that purchase access to the unbundled local switch."²⁰⁹ Although Ameritech gained an admission in the FCC's UNE Order that "the routing aspect of the local switching element may be proprietary," the FCC argued that the routing table may meet the Act's necessary standard and, even if it does not, it meets the impair standard, is not a basis on which Ameritech competes or differentiates its product, and finally that withholding it would jeopardize the goals of the Act.²¹⁰ Thus, like the trunk port issue, the routing table issue is now at least temporarily resolved.

Part of the concerns over local transport and switching involved Ameritech's treatment of end-to-end service as a resale item, which entitled Ameritech to retain access charges, even if the service was provided over combined UNEs (unless the CLEC satisfied Ameritech's requirement that the service be provided over a dedicated trunk and dedicated trunk port). This view provides the basis for Ameritech's refusal to provide shared local trunking and shared trunk ports²¹¹ and is at odds with section 251(c)(3) of the Act, which requires that "[a]n incumbent local exchange carrier shall provide such unbundled network elements in a manner that allows requesting carriers to combine such elements in order to provide . . . [a] telecommunications service."²¹² In the *Local Competition Order*, the FCC issued rules requiring that CLECs be permitted to combine UNEs to provide end-to-end services,²¹³ and these rules were upheld by both the Eighth Circuit and the Supreme Court.²¹⁴ Also, the *Access Reform Order*

207. See *UNE Order*, FCC 99-238, 1999 WL 1008985 (1999).

208. See NEWTON'S TELECOM DICTIONARY 979 (9th ed. 1995).

209. *Third Reconsideration Order*, 12 F.C.C.R. 12,460, para. 23, 8 Comm. Reg. (P & F) 1206.

210. *UNE Order*, FCC 99-238, 1999 WL 1008985, paras. 247-52.

211. See *Michigan Order*, 12 F.C.C.R. 20,543, para. 324, 9 Comm. Reg. (P & F) 267 (1997).

212. 47 U.S.C. § 251(c)(3) (1994 & Supp. III 1997).

213. See 47 C.F.R. § 51.315(a) (1998).

214. The Eighth Circuit rejected the rules that require BOCs to combine UNEs on behalf

clearly eliminates access charges in this case.²¹⁵ Since the FCC's reinterpretation of the necessary and impairment standards continues to regard shared local trunking and shared trunk ports as UNEs, Ameritech's treatment of end-to-end service as resale is untenable.²¹⁶

This issue arose in South Carolina and Louisiana as well because BellSouth's SGATs promised neither access to UNEs for purposes of combining them nor enough specificity on collocation arrangements to enable a determination that CLECs would be able to combine.²¹⁷ For example, charges for physical collocation space preparation in a BellSouth central office were unspecified in BellSouth's SGATs. The SGATs also did not provide combining charges in the event that BellSouth combines UNEs on behalf of a CLEC. BellSouth indicated that, like Ameritech, it would regard end-to-end service as resale and retain the access charges,²¹⁸ in which case there is little need to address combination arrangements. In the *Louisiana II Order*, the FCC concluded that BellSouth's collocation offering provided inadequate interconnection arrangements, and explicitly used this as a basis for denial.²¹⁹ In particular, the FCC argued that, since the Act requires access to UNEs at all technically feasible points, collocation cannot serve as the only method of combining UNEs. However, the FCC characterized this as a failure to provide access to UNEs. BellSouth achieved FCC acceptance of its shared local transport and local switching offerings in the *Louisiana II Order*. The problems were with access, the OSS used to achieve this access, and whether the BOC must provide vertical features present in the switch as UNEs when the BOC does not offer those features at retail.²²⁰ On this last point, the FCC not only concluded that such features must be provided to CLECs, but further that "a requesting carrier that takes an unbundled local switch *must* pay for all of the vertical features included in the switch, even if it is unable to sell those vertical features to end user customers."²²¹

of CLECs. *See Iowa Utils. Bd. v. FCC*, 120 F.3d 753 (8th Cir. 1997). The Eight Circuit did not reject the rule requiring that CLECs be permitted to combine UNEs. The Supreme Court left intact the rule requiring that BOCs not separate requested, already combined UNEs. *See Iowa Utils. Bd.*, 120 F.3d at 736.

215. *See Access Reform Order*, 12 F.C.C.R. 15,982, para. 337, 7 Comm. Reg. (P & F) 1209 (1997).

216. *See UNE Order*, FCC 99-238, 1999 WL 1008985, paras. 321, 369 (1999).

217. *See South Carolina Order*, 13 F.C.C.R. 539, paras. 185, 197-209, 10 Comm. Reg. (P & F) 870 (1998).

218. *See id.* at para. 210.

219. *See Louisiana II Order*, 13 F.C.C.R. 20,599, paras. 161-65, 13 Comm. Reg. (P & F) 1082 (1998).

220. *See id.* at paras. 202-05, 210, 216-22.

221. *Third Reconsideration Order*, 12 F.C.C.R. 12,460, para. 47, 8 Comm. Reg. (P & F)

These positions taken by Ameritech and BellSouth are inconsistent with the Act as interpreted by the Eighth Circuit and, probably, also as interpreted by the Supreme Court. The *Third Reconsideration Order*, the July 1998 *FCC Summary* on unbundled local transport, and the *UNE Order* all indicate there are unresolved issues concerning transport specifically between a BOC switch and a nonBOC switch when the CLEC does not provide local exchange service, so the FCC has issued a *Fourth Further Notice of Proposed Rulemaking*.²²² Otherwise, the new necessary and impairment standards will require BOCs to make shared local transport and switching accessible with sufficient specificity, including all relevant charges, to assure that combinations and the attendant accounting for access charges are possible, even if combinations are used to provide end-to-end service.²²³

In contrast, the *New York Order* notes that Bell Atlantic offered multiple collocation options that can be used to combine UNEs. Further, the actual commercial usage as well as the testing performed by KPMG evidence nondiscriminatory access, despite some disputes concerning access and certain restrictions imposed by Bell Atlantic, are unresolved pending the outcome of the *Fourth Further Notice of Proposed Rulemaking*.²²⁴ With the OSS and UNE combination issues resolved, Bell Atlantic's unbundled local transport and local switching were remarkably uncontroversial.²²⁵

E. TELRIC Pricing

In the *Local Competition Order*, the FCC presented its theory of pricing for interconnection and UNEs.²²⁶ The central idea is that prices should be based on forward-looking economic cost because, according to the FCC, such prices will encourage efficient entry while discouraging inefficient entry. The operational version of this concept is Total Element Long Run Incremental Cost (TELRIC), a real-world proxy for theoretical long-run marginal cost.

In *Iowa Utilities Board v. FCC*, the Iowa Utilities Board challenged these pricing rules on jurisdictional grounds, arguing that Congress left the specific determination of prices to the states and only granted the FCC

1206 (1997) (emphasis added).

222. See *UNE Order*, FCC 99-238, 1999 WL 1008985, para. 494 (1999).

223. See *id.* at paras. 321, 369.

224. See *New York Order*, FCC 99-404, 1999 WL 1243135, paras. 231-32, 235-36, 240 (Dec. 22, 1999).

225. See *id.* at paras. 338-39, 346.

226. See *Local Competition Order*, 11 F.C.C.R. 15,499, paras. 618-862, 4 Comm. Reg. (P & F) 1 (1996).

authority to decide whether individual state determinations are consistent with statutory standards.²²⁷ In particular, section 252(d)(1)(A) of the Act only requires that interconnection and UNE prices be “based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable), and . . . [be] nondiscriminatory.”²²⁸ On July 18, 1997, the Eighth Circuit agreed that the FCC had exceeded its authority and vacated the TELRIC pricing rules.

This ruling provides the backdrop for the *Michigan Order*, which was issued only thirty-two days later. No part of the formal determination in the *Michigan Order* relies on an evaluation of interconnection and UNE prices. But the FCC included advisory opinions which, while acknowledging that the Eighth Circuit’s ruling made it impossible for the agency to insist on TELRIC prices in a review of section 252(d) compliance, nevertheless indicated that the agency intended to use TELRIC principles in determining whether a BOC is in compliance with the checklist and in making a public interest determination.²²⁹ This prompted the Iowa Utilities Board to file another complaint asking the Eighth Circuit Court to enforce its earlier decision.²³⁰ Before the court decided this second complaint, new commissioners were appointed to the FCC and they rendered the *Order* on BellSouth’s South Carolina Application.

The *South Carolina Order* contains no reference to TELRIC and bases its denial only on the failure to satisfy either Track A or Track B and the failure to satisfy the checklist due to problems with OSS, inadequate access and specificity regarding UNEs—particularly with regard to combining of UNEs—and refusal to offer resale of certain services. The separate statements of Commissioners Ness and Powell, however, indicate division among the new commissioners over the TELRIC issue. Commissioner Ness, while acknowledging that the “pricing provisions of our *Interconnection Order* have been voided,” continues that she does “not read the [Eighth] Circuit’s rulings as curtailing the FCC’s role in determinations on Bell company applications to offer long-distance services,” and that she “can find no statutory basis for treating the determinations of state commissions—whether on pricing or on any other checklist items—as dispositive for [s]ection 271 purposes.”²³¹ In contrast,

227. See *Iowa Utils. Bd. v. FCC*, 120 F.3d 753, 792 (8th Cir. 1997).

228. 47 U.S.C. § 252(d)(1)(A) (1994 & Supp. III 1997).

229. See *Michigan Order*, 12 F.C.C.R. 20,543, paras. 288-90, 9 Comm. Reg. (P & F) 267 (1997).

230. See *Iowa Utils. Bd. v. FCC*, 135 F.3d 535 (8th Cir. 1998).

231. *South Carolina Order*, 13 F.C.C.R. 539, 679, 10 Comm. Reg. (P & F) 870, 949 (1998) (Separate Statement of Commissioner Susan Ness).

Commissioner Powell states that he “respect[s] the genuinely held view of some that the statute confers independent jurisdiction on the Commission to establish pricing rules. I merely note that such an interpretation is not universally shared among the Commissioners.”²³²

Twenty-nine days later the Eighth Circuit issued its second ruling—again in favor of the Iowa Utilities Board—ordering the FCC to cease and desist from applying its pricing rules in both its checklist review and its public interest determination.²³³ The court was clearly angered by the FCC’s continuing pursuit of TELRIC and chastised the agency for violating “this central tenet of our decision” and making “clear its intention to disregard those portions of our decision.”²³⁴ The court went on to accuse the FCC of “intimidat[ing]” and “coerc[ing] state commissions,” using “indirect[ion]” to pursue its policy goals, lacking “even the scent of merit” in reasserting its local pricing authority, and attempting to “evade ordinary appellate review” in “an attempt to forum-shop.”²³⁵

In response, the FCC made no mention of TELRIC in its *Louisiana Order* and, notably, explicitly avoided pricing issues in the *FCC Summary*. The agency also strictly honored the *Iowa Utilities Board v. FCC* decision in the *Louisiana II Order*, declaring that “our [pricing] inquiry is complete” after doing nothing more than confirming that “the Louisiana Commission advises us that BellSouth’s prices conform with its rules.”²³⁶ This capitulation appears half-hearted, however, as the agency’s evaluation of the unbundled local switching UNE quotes the Department of Justice, which continues “to question whether competitors wishing to offer services that use BellSouth’s unbundled switching and vertical features are being competitively disadvantaged by unreasonably high prices for those unbundled elements.”²³⁷ While no formal determination was based on this observation, the quote clearly misses the point that, according to the Eighth Circuit Court, the FCC had no statutory basis to consider whether UNE prices were unreasonably high once the agency determined that the prices indeed conformed to the Louisiana Commission’s rules, no matter what the Department of Justice opined.

On January 25, 1999, the Supreme Court decided the challenge to *Iowa Utilities Board* by largely reversing the Eighth Circuit. In particular,

232. *Id.* at 685 (Separate Statement of Commissioner Michael K. Powell).

233. *See Iowa Utils. Bd.*, 135 F.3d at 543.

234. *Id.* at 537-38 (citation omitted).

235. *Id.* at 539, 541-42.

236. *Louisiana II Order*, 13 F.C.C.R. 20,599, para. 60, 13 Comm. Reg. (P & F) 1082 (1998).

237. *Id.* at para. 210 n.677.

the Court found that the FCC's TELRIC pricing rules do not exceed the agency's jurisdiction. This opinion was based on the Court's conclusion that the FCC "has explicitly been given rulemaking authority"²³⁸ over pricing methodology because Congress inserted the 1996 Act into the Communications Act of 1934, which states that the FCC "may prescribe such rules and regulations as may be necessary in the public interest to carry out the provisions of this chapter."²³⁹ Justice Scalia, writing for the majority, opined that 47 U.S.C. § 152(b) did not affect their view.²⁴⁰

Under the Court's interpretation, the key language here is *apply* and *give jurisdiction*. Essentially, the Court's view is unaffected by this section because much of the 1996 Act does *apply* to intrastate service and some of the 1996 Act *gives jurisdiction* to the FCC over intrastate service. Therefore, the Court concluded that Congress must have intended to cross the jurisdictional fence, and the only remaining question is how far. This is where Justice Thomas, writing for the minority, disagrees with the majority opinion: "In my view, the majority's interpretation of [section] 201(b) necessarily implies that Congress *sub silentio* rendered [section] 2(b)²⁴¹ a nullity by extending federal law to cover intrastate communications."²⁴² Justice Thomas concluded that "the majority . . . must also point to 'unambiguous' and 'straightforward' evidence that Congress intended to eliminate [section] 2(b)'s 'substantive jurisdictional limitation'"²⁴³ and that "Congress neither eliminated section 2(b) altogether nor added [sections] 251 and 252 [containing the provisions on interconnection, unbundling, and pricing] to the list of provisions exempted from its jurisdictional fence."²⁴⁴

The Supreme Court remanded the case back to the Eighth Circuit, which heard oral arguments on September 17, 1999. These arguments address whether TELRIC pricing satisfies the statutory standards for interconnection and UNE prices.²⁴⁵ Hence, whether the TELRIC prices being used in many states, based on the FCC's earlier advice, are consistent with the Act is yet to be determined. Despite this, in the *New York Order*

238. AT&T Corp. v. Iowa Utils. Bd., 119 S. Ct. 721, 731 n.7 (1999).

239. 47 U. S. C. § 201(b) (1994).

240. See AT&T Corp., 119 S. Ct. at 730.

241. This refers to the Communications Act of 1934.

242. AT&T Corp., 119 S. Ct. at 744 (Thomas, J., dissenting).

243. *Id.* at 744.

244. *Id.*

245. Oral arguments heard before the U.S. Court of Appeals for the Eighth Circuit, in Iowa Utilities Board v. FCC, September 17, 1999, as transcribed for the law firm of Kellog, Huber, Hansen, Todd, & Evans PLLC, Washington, D.C. See *1999 Filings* (visited Jan. 31, 2000) <<http://ls.wustl.edu/8th.cir/FCC/fcc.html>>.

the FCC interprets the Supreme Court's decision as granting permission to impose TELRIC prices, stating that "a BOC *must* show that its prices for interconnection and unbundled network elements are based on forward-looking, long-run incremental costs" (i.e., TELRIC).²⁴⁶ The FCC shows substantial deference, however, to the New York Public Service Commissions pricing determinations and essentially relies on them for checklist compliance.²⁴⁷

To some degree, the Act's ambiguity and the attendant legal maneuvering simply reflect disagreement over the basic economics of TELRIC pricing. The economic motivation for TELRIC prices is that, theoretically, prices equal long-run marginal cost in competitive markets in long-run equilibrium. Hence, any firm that can achieve the theoretical long-run level of cost efficiency can participate in a market in which its input prices are set at TELRIC levels, while any firm that cannot achieve this efficiency will not survive in such a market. In this way, it is argued, TELRIC prices mimic the outcome of competitive markets, only allowing efficient firms to survive.

There are two main objections to this argument. The first is that BOC costs may not be at this theoretical minimal level because the regulated environment in which many of those costs were incurred forced or encouraged the BOC to depart from the theoretical minimum. This is the stranded or embedded cost argument. The second is that the long-run is very long indeed for industries with large sunk costs, and if technology is advancing more rapidly than this, then even a perfectly competitive industry will not price at this very low level because under these conditions such prices never recover sunk costs. This argument is advanced by Hausman, who also argues that the failure to recover sunk costs diminishes incentives for both incumbents and entrants to invest in telecommunications infrastructure.²⁴⁸ In other words, the TELRIC focus on a static long-run equilibrium is inappropriate for an industry in which the dynamics consist of technological improvements occurring faster than the industry can reach a static long-run equilibrium. This is the anticipatory retardation argument advanced by Alfred Kahn.²⁴⁹ The debate over which view is correct for the telecommunications industry is unresolved.

246. *New York Order*, FCC 99-404, 1999 WL 1243135, para. 237 (Dec. 22, 1999) (emphasis added).

247. *See id.* at 238, 240, 259.

248. *See* Hausman, *supra* note 126, at 1-38.

249. *See* Southwestern Bell Tel. Co.'s Direct Testimony of Alfred E. Kahn at 5 (Tex. Pub. Util. Comm'n Sept. 15, 1997) (Nos. 16189, 16196, 16226, 16285, 16290, 16455, 17579, 17587, 17781).

F. *Pick and Choose*

Section 252(i) of the Act requires that “[a] local exchange carrier . . . make available any interconnection, service, or network element provided under an agreement approved under this section to which it is a party to any other requesting telecommunications carrier upon the same terms and conditions as those provided in the agreement.”²⁵⁰ In the *Local Competition Order*, the FCC interpreted this section to mean that BOCs had to allow CLECs to obtain any individual interconnection, service, or UNE at the terms specified in an existing agreement, even if the CLEC did not want other parts of the agreement.²⁵¹

This rule became known as pick and choose and was challenged along with the entire *Local Competition Order* in *Iowa Utilities Board v. FCC*.²⁵² Like TELRIC pricing, the Eighth Circuit vacated this rule and ruled that BOCs need only make existing agreements available to CLECs *in their entirety* in order to be providing interconnection, services, and UNEs upon the same terms and conditions.²⁵³ But also like TELRIC pricing, the FCC subsequently issued guidance that the availability of pick and choose is demonstrative of efforts to open local markets and may be considered as part of its public interest determination in future applications.²⁵⁴ In the complaint requesting that the Eighth Circuit enforce its earlier ruling, the Iowa Utilities Board did not request, and the court, therefore, did not consider whether the FCC’s guidance on pick and choose violated the first *Iowa Utilities Board* decision. The Supreme Court, however, heard arguments on pick and choose in *AT&T Corp. v. FCC*, as part of the broad challenge to the *Iowa Utilities Board* decision.²⁵⁵ Like TELRIC, the Court overturned the Eighth Circuit on pick and choose, thereby reinstating the FCC’s rule.²⁵⁶ The Court held that the “FCC’s interpretation is not only reasonable, it is the most readily apparent,” because it “tracks the pertinent statutory language almost exactly.”²⁵⁷

Reinstatement of pick and choose is due to the Supreme Court’s view that the FCC gave a reasonable reading of the statute. This view does not address whether pick and choose is sound policy. Indeed, the proposition

250. 47 U.S.C. § 252(i) (1994 & Supp. III 1997).

251. See *Local Competition Order*, 11 F.C.C.R. 15,499, para. 1310, 4 Comm. Reg. (P & F) 1 (1996).

252. See *Iowa Utils. Bd. v. FCC*, 120 F.3d 753, 800-01 (8th Cir. 1998).

253. See *id.* at 801.

254. See *Michigan Order*, 12 F.C.C.R. 20,543, para. 392, 9 Comm. Reg. (P & F) 267 (1997).

255. See *AT&T Corp. v. Iowa Utils. Bd.*, 119 S. Ct. 721 (1999).

256. See *id.*

257. *Id.* at 738.

that “[a] carrier who wants one term from an existing agreement . . . should be required to accept all the terms in the agreement” was characterized by the Supreme Court as seeming “eminently fair.”²⁵⁸ The economics of pick and choose is superficially equivocal as well. The rule undoubtedly decreases entry barriers at a given point in time by making more options immediately available to every CLEC. But the rule must also have a chilling effect on negotiations, reducing the chance for the parties to compromise. Since agreements between businesses operating in competitive markets routinely have at least some customized terms and conditions, available evidence suggests that private agreements have an economic function in competitive markets.²⁵⁹ Moreover, economic theory broadly suggests that the ability to construct complete contracts enhances welfare.²⁶⁰ Thus, when properly viewed over time, the pick and choose rule appears to be anticompetitive. Since the Supreme Court has chosen to defer to the FCC’s interpretations of an ambiguous statute, the agency’s chosen interpretation is unfortunate indeed.

IV. LESS PROMINENT ISSUES IN THE SECTION 271 ORDERS

Aside from the six contentious issues reviewed in the previous section, numerous other issues are discussed in the six extant section 271 Orders.²⁶¹ Three of these are checklist items (vii) nondiscriminatory access to 911 and E911 services, (ix) nondiscriminatory access to telephone numbers, and (iv) availability of resale. Prior to the *New York Order*, the FCC considered two of the structural requirements and the nondiscrimination requirements involved in the third broad condition for BOC entry as well. Finally, this Part discusses four other issues that the FCC has mentioned as part of its general guidance to future applicants regarding the public interest determination that is the fourth broad condition for BOC entry.

A. *Further Checklist Items*

In both the *Michigan* and *South Carolina Orders*, the FCC discusses

258. *Id.*

259. See PAUL MILGROM & JOHN ROBERTS, *ECONOMICS, ORGANIZATION, AND MANAGEMENT* 24, 127-29 (1992).

260. See *id.*

261. See *New York Order*, FCC 99-404, 1999 WL 1243135 (Dec. 22, 1999); *Oklahoma Order*, 12 F.C.C.R. 8685, 8 Comm. Reg. (P & F) 198 (1997); *Louisiana Order*, 13 F.C.C.R. 6245, 11 Comm. Reg. (P & F) 328 (1998); *Louisiana II Order*, 13 F.C.C.R. 20,599, 13 Comm. Reg. (P & F) 1082 (1998); *Michigan Order*, 12 F.C.C.R. 20,543, 9 Comm. Reg. (P & F) 267 (1997); *South Carolina Order*, 13 F.C.C.R. 539, 10 Comm. Reg. (P & F) 870 (1998).

reliability of 911 and E911 databases for CLEC customers.²⁶² The FCC found a lack of parity between Ameritech and its rivals in Michigan and cited this as a reason for denial.²⁶³ Although there is some dispute in the record surrounding the *South Carolina Order*, the FCC ultimately determined that BellSouth satisfied this checklist item in South Carolina and also in the *Louisiana II* proceeding.²⁶⁴ Apparently, for some CLEC customers in Michigan, Ameritech's records were incomplete or were improperly entered into databases, resulting in the name and/or address of the CLEC appearing in the E911 database rather than the proper customer information. Three instances are cited in the *Michigan Order* in which emergency personnel were directed to an incorrect location as a result of such database errors.²⁶⁵ Further study of the databases revealed that the incidence of E911 database errors was substantially higher among CLEC customers than among Ameritech customers, and Ameritech was unable to demonstrate that these errors were ultimately attributable to mistakes made by CLECs.²⁶⁶ There was also an instance of trunks that were used for E911 traffic being deactivated.²⁶⁷ There is little debate that the lack of parity displayed by these circumstances is inconsistent with the statutory requirement of nondiscriminatory access to E911 services. Rather, most of the debate revolved around whether Ameritech had remedied the problems. The FCC determined in the *Michigan Order* that the problems had not been remedied by the time of application.

BellSouth had a policy in South Carolina of restricting the quantity of telephone numbers a CLEC could reserve in advance without placing a similar restriction on itself.²⁶⁸ This restriction was discussed as a possible violation of the checklist requirement that access to OSS be nondiscriminatory but can also be viewed as a violation of the checklist item that access to telephone numbers be nondiscriminatory.²⁶⁹ Although no formal finding was made, BellSouth agreed to drop the restriction.²⁷⁰ BellSouth's OSS access required CLECs to rekey actual orders for service

262. See *Michigan Order*, 12 F.C.C.R. 20,543, paras. 32-33, 9 Comm. Reg. (P & F) 267; *South Carolina Order*, 13 F.C.C.R. 539, paras. 228-29, 10 Comm. Reg. (P & F) 870.

263. See *Michigan Order*, 12 F.C.C.R. 20,543, para. 265, 9 Comm. Reg. (P & F) 267.

264. See *South Carolina Order*, 13 F.C.C.R. 539, para. 230, 10 Comm. Reg. (P & F) 870; *Louisiana II Order*, 13 F.C.C.R. 20,599, para. 236, 13 Comm. Reg. (P & F) 1082.

265. See *Michigan Order*, 12 F.C.C.R. 20,543, para. 260, 9 Comm. Reg. (P & F) 267.

266. See *id.* at para. 267.

267. See *id.* at para. 273.

268. See *South Carolina Order*, 13 F.C.C.R. 539, para. 177, 10 Comm. Reg. (P & F) 870.

269. See *id.* at para. 178.

270. See *id.* at paras. 177-79.

after the preordering phase in which information on installation dates and telephone numbers is provided to a customer. Hence, CLECs had to reserve telephone numbers during the preordering phase in order to assure that their customers would receive the promised telephone number.²⁷¹ This could result in greater use of number reservations by CLECs than by BellSouth, which did not need to reserve telephone numbers prior to placing an order for service because the preordering and ordering functions are essentially simultaneous for BellSouth. It is likely that this type of discriminatory access to telephone numbers will be remedied automatically as part of any remedy for discriminatory OSS access. In the *Louisiana II Order*, BellSouth was found to be in compliance with the checklist item on numbering administration, and Bell Atlantic's OSS eliminated any concerns with numbering assignment in New York.²⁷²

Section 251(c)(4) of the Act imposes on all ILECs—whether or not the ILEC is a BOC—the duty “to offer for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers who are not telecommunications carriers; and . . . not to prohibit, and not to impose unreasonable or discriminatory conditions or limitations on, the resale of such telecommunications service.”²⁷³ In turn, the competitive checklist requires that BOCs provide resale in accordance with this section. This requirement was interpreted in the *Local Competition Order* to mean that anything sold to an end-user is provided at retail and thus must be made available for resale.²⁷⁴ This interpretation was not vacated by the Eighth Circuit decisions but in fact was specifically endorsed as it pertains to discount offerings.²⁷⁵ BellSouth offered volume discounts and other special arrangements to certain customers under agreements known as Contract Service Arrangements (CSAs). With the blessing of the South Carolina Commission, BellSouth refused to offer these CSAs for resale, arguing that they are not subject to the wholesale discount because they are already discounted.²⁷⁶ BellSouth's refusal is in plain violation of the requirement, upheld by the Eighth Circuit, that all services sold to an end-user be offered for resale, and hence, BellSouth's refusal was cited as a

271. *See id.* at paras. 175-76.

272. *See New York Order*, FCC 99-404, 1999 WL 1243135, paras. 91, 132, 364 (Dec. 22, 1999); *Louisiana II Order*, 13 F.C.C.R. 20,599, para. 262, 13 Comm. Reg. (P & F) 1082 (1998).

273. 47 U.S.C. § 251(c)(4) (Supp. II 1996).

274. *See Local Competition Order*, 11 F.C.C.R. 15,499, para. 871, 4 Comm. Reg. (P & F) 1 (1996).

275. *See Iowa Utils. Bd. v. FCC*, 120 F.3d 753, 818-19 (8th Cir. 1997).

276. *See South Carolina Order*, 13 F.C.C.R. 539, para. 214, 10 Comm. Reg. (P & F) 870 (1998).

reason for denial in both South Carolina and Louisiana.²⁷⁷ In the *FCC Summary* on resale, the agency reiterated its conclusion in the *Local Competition Order*, which was upheld by the Eighth Circuit, that CLECs must be allowed to disaggregate volume offerings like CSAs and then resell the disaggregated services.²⁷⁸

This requirement is consistent with the general theory of wholesale discounts contained in the Act and the *Local Competition Order*, but may present new arbitrage opportunities if the wholesale discounts for both CSAs and other services do not truly reflect avoided costs.²⁷⁹ The FCC noted that a different wholesale discount might be appropriate for CSAs than for other retail services, and that heterogeneous discounts of this sort will be allowed as long as they are based on avoided cost as required by the Act.²⁸⁰ Such discounts must be properly determined in a state commission proceeding rather than implicitly offered at zero by a blanket exception for CSAs.²⁸¹ Thus, a separate determination of the appropriate wholesale discount for CSAs is an essential part of the resale scheme. Indeed, the New York Public Service Commission made such determinations prior to Bell Atlantic's application in New York, and the FCC specifically noted this as part of its determination that Bell Atlantic resale offerings in New York meet the statutory standard.²⁸² Even though BellSouth dropped its objection to wholesale discounting of CSA's in the *Louisiana II* proceeding, the FCC still found that the resale checklist item was not satisfied, due to continuing inadequacies in BellSouth's OSS.²⁸³ In the *Louisiana II Order*, the FCC gave explicit determinations on every checklist item. Aside from the items already mentioned, other relatively minor checklist issues arose.²⁸⁴

277. See *id.* at para. 215; *Louisiana Order*, 13 F.C.C.R. 6245, para. 63, 11 Comm. Reg. (P & F) 328 (1998).

278. See *Local Competition Order*, 11 F.C.C.R. 15,499, para. 877, 4 Comm. Reg. (P & F) 1.

279. For arbitrage possibilities created by the Telecommunications Act of 1996 and the *Local Competition Order*, see David M. Mandy & Larry R. Blank, *Resale, Unbundling, and Competition in the Local Exchange: What Have Congress and the FCC Wrought?* (Dec. 1, 1996) (unpublished manuscript, on file with *Federal Communications Law Journal*).

280. See 47 U.S.C. § 252(d)(3) (Supp. II 1996).

281. See *South Carolina Order*, 13 F.C.C.R. 539, paras. 219-20, 10 Comm. Reg. (P & F) 870.

282. See *New York Order*, FCC 99-404, 1999 WL 1243135, paras. 381 n.1178, 385 (Dec. 22, 1999); *South Carolina Order*, 13 F.C.C.R. 539, paras. 219-20, 10 Comm. Reg. (P & F) 870.

283. See *Louisiana II Order*, 13 F.C.C.R. 20,599, para. 309-10, 13 Comm. Reg. (P & F) 1082 (1998).

284. See *id.* These minor checklist items include: performance data on loop provisioning that was not sufficiently disaggregated; unnecessarily long cutover intervals when

B. Structural Requirements

Two potential violations of the structural requirements for a separate long-distance affiliate of the BOC arose in the Michigan proceeding. First, section 272(b)(3) of the Act requires that a BOC's long-distance affiliate "shall have separate officers, directors, and employees from the [BOC] of which it is an affiliate."²⁸⁵ Ameritech Michigan's long-distance affiliate is organized as a closely-held corporation, which under Delaware law (the state of incorporation) is not required to have directors.²⁸⁶ Ameritech argued that, since its long-distance affiliate did not have directors, it automatically satisfied the requirement that its directors be separate.²⁸⁷ According to the FCC, however, the relevant corporate law imposes the duties, responsibilities, and liabilities of directors on the stockholders of a closely-held corporation that does not have its own directors.²⁸⁸ In the case at hand, Ameritech Michigan's long-distance affiliate is one hundred percent owned by the parent BOC, meaning that Ameritech is the *de facto* director.²⁸⁹ The FCC correctly cited this thinly-veiled attempt to circumvent the Act as a reason for denial in Michigan.²⁹⁰

The second potential violation of a structural requirement involves section 272(b)(5), which requires that the separate long-distance affiliate "shall conduct all transactions with the [BOC] of which it is an affiliate on an arm's length basis with any such transactions reduced to writing and available for public inspection."²⁹¹ Ameritech did not include in its public disclosures the prices for services exchanged between the parent BOC and the long-distance affiliate, did not publicly disclose transactions that were concluded before the FCC's *Accounting Safeguards Order* was released, and did not publicly disclose transactions between its long-distance affiliate and other Ameritech affiliates that allegedly sell UNEs and resell retail services.²⁹² First, while the Act does not explicitly require that prices

unbundled loops were switched from one carrier to another; no showing that directory assistance and operator services were offered; and inadequate showing that interim number portability was timely—due to alleged problems coordinating number portability with loop cutovers and some doubts whether BellSouth's pricing of number portability satisfied FCC rules. *See id.*

285. 47 U.S.C. § 272(b)(3) (Supp. II 1996).

286. *See Michigan Order*, 12 F.C.C.R. 20,543, para. 355, 9 Comm. Reg. (P & F) 267 (1997).

287. *See id.* at para. 349.

288. *See id.* at para. 353.

289. *See id.* at para. 354.

290. *See id.* at para. 353.

291. 47 U.S.C. § 272(b)(5) (Supp. II 1996).

292. *See Michigan Order*, 12 F.C.C.R. 20,543, paras. 367-73, 9 Comm. Reg. (P & F) 267 (referring to Implementation of the Telecomms. Act of 1996: Accounting Safeguards

be included in public disclosures, the arm's length standard suggests that prices must be a part of these intraBOC transactions. If Ameritech reduced such an arm's length transaction to writing, as required, then the written transaction made available for public inspection must include prices. Moreover, the FCC interprets the *Accounting Safeguards Order* as requiring that the prices be disclosed.²⁹³ Second, while the FCC has indicated that it may agree to a reduced disclosure standard for transactions concluded prior to the *Accounting Safeguards Order*, there is no exception in the Act for such transactions.²⁹⁴ Third, the alleged nondisclosure certainly violates the spirit of section 272(b)(5).²⁹⁵ Whether this is a legal violation depends on whether Ameritech's other affiliates are, as a matter of law, the BOC referred to in this section of the Act. The FCC maintains that "any successor or assign of the BOC is subject to the section 272 requirements in the same manner as the BOC."²⁹⁶ Hence, each of Ameritech's three nondisclosures probably violates the Act, although the FCC only formally ruled on the first item as a reason for denial in the *Michigan Order*.²⁹⁷

Similar issues arose in the *Louisiana II Order*.²⁹⁸ The FCC concluded that certain transactions between BellSouth and its affiliate had not been disclosed, including the rates, terms, and conditions.²⁹⁹ Perhaps more importantly, the FCC concluded that BellSouth's problematic OSS violated the nondiscrimination safeguards since, as discussed above, it failed to provide access for CLECs at parity with the access BellSouth provided for itself.³⁰⁰

IN contrast, Bell Atlantic has three affiliates for in-region interLATA service, all of which are wholly owned by Bell Atlantic but have separate officers, directors, and employees.³⁰¹ Moreover, although there was some controversy in the New York proceeding concerning Bell Atlantic's disclosures of transactions with its affiliates, the FCC found that Bell

Under the Telecomms. Act of 1996, *Report and Order*, 12 F.C.C.R. 2993, 5 Comm. Reg. (P & F) 861 (1996).

293. *See id.* at para. 369.

294. *See id.* at para. 371.

295. *See* 47 U.S.C. § 272(b)(5) (Supp. II 1996).

296. *Michigan Order*, 12 F.C.C.R. 20,543, para. 373, 9 Comm. Reg. (P & F) 267 (1997) (footnote omitted).

297. *See id.* at para. 367.

298. *See Louisiana II Order*, 13 F.C.C.R. 20,599, para. 91, 13 Comm. Reg. (P & F) 1082 (1998).

299. *See id.* at paras. 332-39.

300. *See id.* at paras. 340-47.

301. *See New York Order*, FCC 99-404, 1999 WL 1243135, paras. 405, 409 (Dec. 22, 1999).

Atlantic met the statutory standard.³⁰²

Part II.B notes that an economic rationale for the separate affiliate requirement is to reduce the incentive for sabotage by separating the decision making of the BOC and its affiliate and also requiring that the BOC deal with its affiliate on the same terms as it deals with other providers of interLATA service. This objective is defeated if the BOC, as director, can dictate the affiliate's policies or can give its affiliate preferential treatment by hiding transactions or the terms of transactions between itself and its affiliate. Thus, the concerns raised over directorship, all three of Ameritech's nondisclosures, BellSouth's nondisclosures, and BellSouth's OSS are consistent with economic theory.

C. Other Public Interest Concerns

An explicit allegation of tying is discussed in the *Michigan Order*. Ameritech was accused of refusing to sell intraLATA toll service to a customer unless that customer also purchased local exchange service from Ameritech.³⁰³ This alleged tie is different from the example mentioned above in Part II.A. Local exchange service is actually the tied good here, while intraLATA toll is the tying good. The objective of Ameritech's alleged tie cannot be to evade regulations on the tying good, since the tied good is also regulated and hence provides little opportunity to extract additional monopoly profit. The objective also cannot be to price discriminate, since the tied good (local exchange service) is not usually priced according to usage. This leaves only foreclosure of the tied good market as a possible undesirable objective for Ameritech's alleged tie-in. Conceivably, Ameritech might benefit from foreclosing the market for local exchange service but not in the traditional way of enabling monopoly pricing in that market since the market is so heavily regulated. The benefit would have to come from being able to sabotage or exercise market power in another market by virtue of controlling the local exchange market. These incentives could be present if the incentive to sabotage is not adequately controlled by regulation, or if consumer preferences for one-stop shopping are strong enough to enable supracompetitive pricing of bundles on the part of the only firm supplying complete service bundles.

But there is another problem with this tying allegation. In order for a tie-in sale to have any chance of accomplishing the undesirable objectives for tying discussed in Part II.A., the tying firm must possess power in the tying good's market. To the extent that intraLATA dialing parity was not

302. See *id.* at paras. 411-414.

303. See *Michigan Order*, 12 F.C.C.R. 20,543, para. 377, 9 Comm. Reg. (P & F) 267 (1997).

implemented in Michigan, Ameritech did possess some market power in the market for intraLATA services. It is not clear whether that power was sufficient to cause much difficulty in other markets, since consumers could easily dial around Ameritech in the event Ameritech charged supra-competitive prices for its one-stop shopping bundles. Experience with equal access in interLATA markets suggests that substantial market power persists at least until dialing parity is established. Even if this experience is mirrored in intraLATA markets, the market power will be reduced exactly when Ameritech is given access to the markets in which the power might be exercised. This is because the Act explicitly requires intraLATA toll dialing parity as a condition for selling interLATA services. Section 271(e)(2)(A) states: "A [BOC] granted authority to provide interLATA services under subsection (d) of this section shall provide intraLATA toll dialing parity throughout that State coincident with its exercise of that authority."³⁰⁴ Hence, Ameritech's alleged tie-in must stem from a welfare-enhancing objective and thus should be of no concern to regulators.

In conclusion, the alleged tie is not *itself* a cause for concern. This does not mean that a BOC's potential market power in one-stop shopping is benign. It simply means that the BOC gains nothing in the exercise of any monopoly power by tying. Any such monopoly power can be exercised without tying by setting prices for one-stop bundles above costs, while still allowing the purchase of separate components of the bundles so there is no *required* tie. If the BOC is the only supplier of one-stop bundles, perhaps due to monopoly provision of local exchange service, then the potential exists for bundles to be priced above cost, to the extent consumers place higher value on bundles. The extent of monopoly power over bundles is debatable since any reseller can, in principle, provide all the same bundles that the BOC can provide. However, product differentiation can create market power, therefore BOCs may be able to price bundles above cost if there are real or perceived quality differences. However, the real problem in this scenario is the monopoly power created by product differentiation, not any uniqueness in the BOC's ability to offer bundles.

Ameritech's "ValueLink" and "Winback" programs are also mentioned in the *Michigan Order* as potentially anticompetitive.³⁰⁵ ValueLink offers low prices on intraLATA services in exchange for committing to a termination fee.³⁰⁶ If consumers are relatively ill-informed when they commit to ValueLink and make this commitment without

304. 47 U.S.C. § 271(e)(2)(A) (Supp. II 1996).

305. See *Michigan Order*, 12 F.C.C.R. 20,543, paras. 377-78, 9 Comm. Reg. (P & F) 267.

306. See *id.* at paras. 377-78.

knowledge of future more advantageous offerings that will become available, the plan could decrease consumer welfare. Such a decrease might occur if consumers' marginal decisions to switch to a more advantageous plan are sufficiently impacted by the termination fee. But a determination of the net effect on welfare must tradeoff the welfare benefits consumers receive in the short-run from the lower ValueLink prices against any subsequent welfare losses. The short-run benefits are likely to dominate unless the commitment to the termination penalty is lengthy. These same considerations apply to termination fees that are included in CSAs, which were mentioned as an item of concern in the *South Carolina Order*.³⁰⁷ For CSAs, a welfare loss due to the termination fee is even less likely because the consumers of CSAs are usually larger, better-informed purchasers. The main concern, however, expressed over termination fees in CSAs is whether they apply when a CLEC resells the services obtained through the CSA. Bell Atlantic satisfied the FCC's concerns over termination fees for CSAs by only imposing the fees if the CSA is terminated, not if the CSA is assigned.³⁰⁸

Although not firmly established in the *Michigan Order*, Ameritech's "Winback" program allegedly misused customer proprietary network information (CPNI) in order to win back customers who switched their local exchange service to a CLEC.³⁰⁹ If Ameritech knows of a customer's status from its role in forwarding customer service records to the CLEC, this is a violation of section 222(c)(1) of the Act unless the customer has agreed in writing to allow Ameritech to use the information.³¹⁰ Ameritech argued that customers had agreed to let their information be used for marketing but apparently did not produce any documents that demonstrated this agreement in writing.³¹¹ Alternatively, if a BOC identifies a group of CLEC customers by comparing its own customer list to a publicly-available directory and then targets this group for marketing, this may not be a violation of the Act. The *Michigan Order* is not specific enough to determine exactly how Ameritech identified customers for marketing and the allegation was not ruled on by the FCC.³¹² Use of CPNI for marketing purposes has the potential to enable price discrimination, allowing the ILEC to determine which consumers must be offered a lower price due to their more elastic demand, as evidenced by their willingness to switch to a

307. See *South Carolina Order*, 13 F.C.C.R. 539, para. 222, 10 Comm. Reg. (P & F) 870 (1998).

308. See *New York Order*, FCC 99-404, 1999 WL 1243135, para. 390 (Dec. 22, 1999).

309. See *Michigan Order*, 12 F.C.C.R. 20,543, para. 379, 9 Comm. Reg. (P & F) 267.

310. See 47 U.S.C. § 222(c)(1) (Supp. II 1996).

311. See *Michigan Order*, 12 F.C.C.R. 20,543, para. 380, 9 Comm. Reg. (P & F) 267.

312. See *id.* at para. 380.

CLEC. Once again, the welfare effects of this price discrimination are ambiguous because high-elasticity consumers benefit from lower prices, while low-elasticity consumers will actually be charged higher prices since the ILEC need not worry as much about driving customers away. This approach has been used by IXCs, who market more aggressive prices to consumers that switch to a competitor, but this can be viewed as a natural result of competition as long as all competitors have equal access to the information that is used for marketing. Without such equal access, an otherwise less-efficient firm can compete solely on the basis of a marketing cost advantage, which can harm welfare. In the *UNE Order*, the FCC again warned that Winback must be administered in a nondiscriminatory manner.³¹³

A different public interest concern expressed in the *Michigan Order* is the availability of all three methods (resale, UNEs, and facilities) of entry.³¹⁴ This is a broad concern but overall the Act clearly imposes requirements that are designed to force BOCs to accommodate all three methods. Economic theory is more equivocal on this issue. As discussed herein, reducing entry barriers helps to bring the benefits of competition to the local exchange market, reduces incentives to raise rivals' costs, and may eliminate some undesirable incentives to tie sales. However, the particular manner in which the three methods interact creates some undesirable incentives. In particular, the simultaneous presence of these methods encourages arbitrage on the part of entrants that is unrelated to the actual cost of providing service.³¹⁵ One version of this arbitrage involves focusing primarily on business customers and using UNEs and facilities to serve them. UNE prices (and of course facility costs) are cost-based and access provided over UNEs is not subject to access charges, while existing retail business prices are above cost. In conjunction with this, resale is used to serve residential customers, because wholesale prices are not cost-based but instead are tied to the frequently below-cost retail prices for residential service.³¹⁶ The incentives for this type of arbitrage can only be removed by allowing residential prices to reflect cost and then making certain that any gap between cost and a politically-acceptable target price is covered with a competitively-neutral universal service mechanism.

313. See *UNE Order*, FCC 99-238, 1999 WL 1008985, para. 436 n.854 (1999).

314. See *id.* at para. 387.

315. See Mandy & Blank, *supra* note 279.

316. Some mild evidence of this appears in the *Michigan Order*. TCG and MFS WorldCom exclusively serve business customers in Michigan, while 73% of Brooks Fiber's access lines are for business service. See *Michigan Order*, 12 F.C.C.R. 20,543, paras. 64-68, 9 Comm. Reg. (P & F) 267. Neither Brooks nor TCG use resale, while the intensity with which WorldCom uses resale is disputed in the record. See *id.*

Yet another public interest concern raised in the *Michigan Order* is the level of performance monitoring and future commitment offered by Ameritech.³¹⁷ This is reemphasized in the *Louisiana II Order* and the *New York Order*.³¹⁸ As mentioned above in Part II.B., monitoring and penalty structures play a role in preventing sabotage. Future commitments to reduce entry barriers in markets for local exchange service play a role too, in that competition in local exchange markets helps deter sabotage and undesirable tie-ins, in addition to the direct benefits competition brings in the form of a price/service mix that is most advantageous for consumers. The harm from insistence on stringent performance monitoring arrangements and future commitments before allowing interLATA entry is twofold, also as discussed in Part II.B. First is the opportunity cost of delayed long-distance competition. Second, to the extent that the link between interLATA entry and local competition delays local competition, additional opportunity costs accrue. Regarding whether required performance monitoring and future commitments are consistent with the Act, section 271(d)(6) grants the FCC clear authority to enforce continuing compliance with the requirements for BOCs' interLATA entry.³¹⁹ This section enables a formal complaint process to review allegations of postentry BOC noncompliance. This section does not, however, grant authority to prejudge future compliance. Thus, *ex ante* requirements that BOCs agree to report on performance and adhere to certain commitments outside of a formal complaint process must be regarded as part of the FCC's public interest determination, and are presented as such in the *New York Order*.³²⁰

A final area of concern mentioned in the *Michigan Order* is the possible role of nonrecurring charges and state and local policies as barriers to entry into the market for local exchange service.³²¹ Nonrecurring charges are only an entry barrier if they are sunk. As long as CLECs can freely sublease the access whose acquisition involves nonrecurring costs or otherwise recoup the market value of such access through, for example, a merger, there is no sunk cost involved. For instance, a space preparation fee for a collocation space is not sunk if CLECs can buy and sell their access and usage rights to the collocation space on an open market.

317. *See id.* at paras. 393-94, 399-400.

318. *See New York Order*, FCC 99-404, 1999 WL 1243135, paras. 431-433 (Dec. 22, 1999); *Louisiana II Order*, 13 F.C.C.R. 20,599, paras. 363-64, 13 Comm. Reg. (P & F) 1082 (1998).

319. *See* 47 U.S.C. § 271(d)(6) (Supp. II 1996).

320. *See New York Order*, FCC 99-404, 1999 WL 1243135, paras. 433-434.

321. *See Michigan Order*, 12 F.C.C.R. 20,543, paras. 395-96, 9 Comm. Reg. (P & F) 267.

Whether this type of trading would be opposed by BOCs and, if so enforced by regulators, has not been addressed in the extant Orders.

With regard to government policies, it is obvious that governments can erect entry barriers and that entry barriers can harm economic welfare.³²² The issue is whether the FCC has authority to police—through the section 271 application process—what the agency perceives as an entry barrier created by a state or local policy. Certain powers are clearly left to the states by the Act. For example, even the majority opinion in *AT&T Corp. v. Iowa Utilities Board* admits that the states have some discretion in setting UNE and interconnection prices under the FCC's TELRIC rubric.³²³ More broadly, if a state or local policy is consistent with the powers left to those governments by the Telecommunications Act, the FCC would be in danger of exceeding its authority by basing a section 271 application denial on a determination that the approval does not serve the public interest because the policy in question erects an entry barrier.³²⁴ The balance of power between the states and the FCC is contentious and difficult to judge hypothetically. But it seems virtually certain that the FCC will generate a court challenge if the agency bases a future section 271 application denial on what it deems to be state and local policies that erected entry barriers.

V. CONCLUSION

A. *Summary of Questionable FCC Positions*

In the preceding sections, seven opinions expressed by the FCC as either actual or potential reasons for denying a section 271 application were identified as questionable for either economic or statutory reasons. First is the interpretation of Track B compliance. The agency's interpretation creates perverse incentives and has the potential to unnecessarily forestall BOC entry for a lengthy period. However, the courts have ruled it is consistent with the Act.

Second is TELRIC pricing. There is substantial legal and economic disagreement surrounding the FCC's advocacy of TELRIC, even at the

322. Government-erected entry barriers do not always harm welfare. For example, the entire economic logic of granting a franchise monopoly to a public utility rests on the notion that the utility is an unsustainable natural monopoly which must be protected in order to achieve productive efficiency.

323. "The FCC's prescription, through rulemaking, of a requisite pricing methodology no more prevents the [s]tates from establishing rates than do the statutory 'Pricing standards' set forth in [section] 252(d) [of the Act]. It is the States that will apply those standards and implement that methodology, determining the concrete result in particular circumstances." *AT&T Corp. v. Iowa Utils. Bd.*, 119 S. Ct. 721 732 (1999).

324. *See* 47 U.S.C. § 271 (Supp. II 1996).

Supreme Court. This suggests that the agency should reconsider the policy, and at least grant the states substantial latitude in deciding what prices meet the TELRIC standard. Substantial inertia toward TELRIC was created by the *Local Competition Order*,³²⁵ and state commissions now need to consider the criticisms of TELRIC and decide what version of TELRIC is right for their state and whether their version is likely to survive FCC scrutiny. Although the FCC insisted on TELRIC in its approval of Bell Atlantic's New York application, the Eighth Circuit has not yet ruled on whether TELRIC is consistent with the Act.³²⁶

The remaining five opinions all pertain to the FCC's view of its public interest determination. Pick and choose apparently remained on the agency's agenda, despite the *Iowa Utilities Board* decision, and that persistence has now been legally vindicated by the *AT&T Corp.* decision. But even the Supreme Court has doubts about the economics of pick and choose. This rule is very similar to a most favored nation clause, which is usually viewed with suspicion because of its anticompetitive effects.³²⁷ Yet the FCC continues to insist that BOCs signal their commitment to competition by agreeing to such rules.

Allegations of tying also attract the agency's attention but with little consideration of the true welfare effects of the alleged tie. Tying local exchange service to intraLATA simply cannot be harmful to consumers in the presence of intraLATA equal access.

Furthermore, concerns with termination fees seem to ignore the welfare-enhancing effects of lower prices during the term of the commitment. Also ignored is the impossibility of reducing welfare through an *optional* price offering, unless consumers are substantially uninformed.

Misuse of proprietary information is a serious allegation, and the FCC appropriately attaches importance to such charges. But conducting a marketing campaign that can be carried out with publicly available information and that offers consumers lower prices is of little concern. In this case the BOC simply must be instructed to make certain it organizes its campaign around generally available data.

Nonrecurring charges are only a concern if they are sunk. The FCC has yet to adequately address the question of whether such charges are sunk. Finally, while it is understandable that concern exists over the entry-detering effects of some state and local policies, such policies may be outside the agency's jurisdiction.

325. See *Local Competition Order*, 11 F.C.C.R. 15,499, 4 Comm. Reg. (P & F) 1 (1996).

326. See *New York Order*, FCC 99-404, 1999 WL 1243135, para. 238 (Dec. 22, 1999).

327. See Thomas E. Cooper, *Most Favored Customer Pricing and Tacit Collusion*, 17 RAND J. ECON. 377 (1986).

B. Summary of Sound FCC Positions

There are many opinions and decisions of the FCC expressed as either actual or potential reasons for denying or approving a section 271 application that are carefully considered, sound economically, and well within the agency's charge. For these, actions that future applicants and state commissions can undertake to strengthen the applications have either been suggested by the FCC or naturally suggest themselves. In general, the agency's evaluation of checklist compliance has been especially strong (except its insistence on TELRIC).

First, it is clear that CLECs must receive access to OSS that approaches parity. The FCC advised that comparative data on true average installation intervals (not percentage of commitments met) be reported in future applications. Demonstrative is comparative data on frequency of problem orders (order flow-through rates), although the FCC evaluated other measures in lieu of these in the *New York Order*; average inform intervals for reporting such problems; and inform intervals for order confirmations and completions.³²⁸ In the *Louisiana II Order*, the FCC explicitly invited statistical analyses of whether differences in these statistics between the BOC and CLECs are significant and considered such analyses in the *New York Order*.³²⁹

Second, consumers must be oblivious to interconnection. The FCC has advised that true comparative trunk blocking rates be reported, a sound suggestion that was followed in New York, although the agency should guard against placing undue weight on CLECs' views of equal quality.³³⁰

Third, to reduce entry barriers access to unbundled local transport and switching must be superior to that offered by Ameritech and BellSouth. The existing rules and statutory interpretations make it clear that BOCs cannot arbitrarily label an end-to-end service as resale simply because it is not carried over dedicated facilities. Truly shared trunk and trunk port UNEs must be included in interconnection agreements and/or SGATs, with the methods used to meter usage explicitly specified. It must be explicit that local switching UNEs include the necessary features. SGATs and/or interconnection agreements also need to completely specify access and combination methods and all relevant charges. The FCC has suggested that data be reported on the time it takes to actually accomplish physical or virtual collocation.³³¹ The Bell Atlantic explicitly addresses all of these

328. See *New York Order*, FCC 99-404, 1999 WL 1243135, paras. 161-63.

329. See *id.* at app. b.

330. See *id.* at para. 69.

331. See *South Carolina Order*, 13 F.C.C.R. 539, para. 93, 10 Comm. Reg. (P & F) 870 (1998).

issues its New York application.

Fourth, it is inadequate to simply make efforts to solve problems with E911. The reliability of these systems is too politically sensitive for local competition to proceed without the same high quality that BOCs have traditionally provided. The FCC has suggested that applications include comparative error rates in E911 databases. Databases, although the agency relied on the declarations of Bell Atlantic, KPMG, and the New York Public Service Commission in the *New York Order*.³³²

Fifth, resale of volume-discounted services is required, but its success depends on correct pricing. Interconnection agreements and SGATs need to specify appropriate, perhaps distinct, wholesale discounts for volume offerings that are determined by the avoided cost from wholesaling volume offerings.

Sixth, the structural requirements and separations safeguards are important in deterring sabotage. Long-distance affiliates must be separately-run and must demonstrate that fact. The requirements are easy to meet if they are adhered to in spirit.

Seventh, although there are some problems with the economics, simultaneous availability of resale, UNEs, and interconnection is dictated by the Act. SGATs and interconnection agreements must make it plain that all three are available.

Finally, there are also some problems with the economics of, and statutory requirements for, performance monitoring and future commitments. However, policies designed to ensure that entry barriers are and will continue to be demonstrably lowered indeed serve the public interest. Section 271 applications can approach these suggestions by including as much specificity as possible.

332. See *New York Order*, FCC 99-404, 1999 WL 1243135, para. 350.