

REMEDIES FOR TELECOM RECOVERY

REGULATION & GOVERNMENT POLICY

**Report of the Advisory Committee
On
Regulation and Government Policy**

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I. SUMMARY OF ADVISORY COMMITTEE DISCUSSIONS

The Advisory Committee had two meetings, both in Washington, D.C. A broad cross-section of the telecommunications industry, including non-U.S. companies, participated. Consumer advocates and State regulators were also represented to balance the industry views. Since a number of representatives were former FCC officials, an FCC viewpoint was also included in the discussions.

The Advisory Committee had a lively debate about the degree to which “regulation” played a role in the telecom boom and bust. For example, did regulatory policies contribute significantly to investor (mis)perceptions about risks and opportunities in a way that contributed to the telecom “bubble?”

The general, but not universal, view of the Committee was that the financial community’s (particularly institutional investors’) enthusiasm was not a reaction to any particular regulatory policy but rather it was a fundamentally flawed analysis of the future of the basic telecom business. For example, investors bid up telecom because they expected that telecom would be more of a “value added,” higher margin business in the Internet Age and be less of a “commodity,” low margin business.

Since regulatory policy was regarded as important to a “commodity” business and not to a “value added” business, investors simply paid less attention to regulation and government policy during the “boom” as their (mis)perception of the value-added nature of the business grew. Now that the bubble has burst and telecom is expected to be a highly “commoditized” business, regulation is only now regarded as a critical factor by investors.

The Committee also generally agreed that regulatory policies which distorted pricing (retail POTs, access charges) caused service providers to “mis-invest” but the mis-investment became obvious only after the bubble burst. The Committee generally agreed that it would benefit the recovery if government stopped “distorting” the telecom market through regulated rates, universal service subsidies, and subsidies of carriers.

Unfortunately, many of the distortions are based in statutes that are impossible to change in the absence of a voter-affecting crisis, so the Committee recognized that the distortive policies are largely “gridlocked” in place. (It was observed that consumers have benefited greatly during both the “boom” and “bust” of the telecom industry and that it would be difficult to convince legislators that there is a need to abolish popular subsidy programs in order to benefit multi-billion dollar companies.) Consequently, the Committee regretfully concluded that it wasn’t reasonable to expect that these distortions could be reduced significantly in a timeframe that could have any impact on the current recovery. That said, it was agreed that a long-term goal of public policy should be to minimize these distortions as much as possible.

Most member of the Committee agreed that the existing system of subsidy distortions is nothing more than the government using the telecom industry as a privatized tax collection and disbursement system. While it might have been a benign and politically expedient system when telecom was a monopoly, the Committee agreed that using the competitive telecom industry as a tax collector and subsidy distributor is now inappropriate. However, the Committee had no expectation that any changes could be made in the near term and members agreed that “second best” solutions for dealing with the collection and disbursement of subsidies would be the best the industry could hope for.

One observation resulting from the preceding discussion was that, for political reasons, it is much easier for government to regulate carriers’ obligations and rates than to manipulate subsidies and since subsidies are so embedded, continued regulation seems to be inevitable.

The Committee also agreed that another area that deserved reform is telecom industry taxes. According to the Council on State Taxation, the telecom industry bears taxes averaging 19 percent of revenues versus only 6 percent for other industries. In addition to these disproportionate taxes (which can suppress demand), the sheer cost to service suppliers of administering a complex system of federal, state and local taxes places a considerable burden on the industry. The reasonable recommendation is that government should not tax telecom any differently from “normal” businesses.

Whether or not regulation contributed significantly to the recent “boom” or “bust,” the more important question is whether regulation will aid or hinder the recovery? The Committee’s thoughts about how regulation relates to “recovery” of the telecom sector included the following:

- While “regulation” places claims on corporate earnings and presumably inhibits recovery, “deregulation” didn’t help the airline industry so the “regulation-deregulation” debate may have no relevance to telecom “recovery.”

- Recovery implies some sort of “sustainable” industry structure. How much competition is sustainable and will government policy encourage/support/allow a “sustainable” level of competition?
- If “fundamental economics” are allowed to rule industry structure, the likelihood is that the industry will have three major players. Will government allow this degree of consolidation?
- “Regulatory uncertainty” is worse than the “wrong” regulatory policy when it comes to investor confidence, which is a key to recovery. So, faster, clearer decisions are better than “perfect” decisions that take a long time to develop.
- There is a claim that the success of the wireless industry demonstrates that government policies (i.e., spectrum availability, minimal retail price regulations, etc) determine the success of an industry sector. The counterpoint was that wireless (and the largely deregulated DSL service) are not covering their cost of capital so there is no meaningful correlation between financial performance and the degree of regulation.

The Advisory Committee also considered a fundamental question: “Is there a case for continuing the regulation of telecommunications services?”

Three preliminary observations were made:

1. Antitrust and consumer protection laws overlap some areas of “telecom regulation” so that there is no need for telecom regulators to duplicate these functions. The assumption was that agencies responsible for broad antitrust and consumer protection enforcement are more expert in these areas and are less likely to be “captured” by a particular industry than an industry-specific regulatory agency such as the FCC.
2. The FCC (and other regulators) has often taken a “hands off” regulatory approach to new developments (i.e., terminal equipment, information services/Internet, broadband) so that the proportion of the “telecom industry” actually being regulated has been decreasing steadily. If the proportion of the total industry that is regulated continues to shrink, as seems likely, at some point it will become rather pointless to continue regulating at all.
3. The regulatory process seems to be unable to match the pace of change and growth of the telecom industry with the result that regulation is increasingly “out of synch” with the industry, making the regulation irrelevant at best and positively harmful at worst. The argument is that if regulation can’t keep up with the industry, it should be eliminated.

This line of discussion led to a general view that it would be desirable and probably necessary to pare down the scope and scale of the FCC's responsibility to something both "necessary" and "manageable".

One way to "pare down" the FCC's responsibilities would be to transfer the FCC's responsibility for competition, industry structure and consumer protection to the two bureaus of the Federal Trade Commission (FTC) that specialize in those subjects. One advantage of the FTC is that it is not focused on any single industry and therefore doesn't get "captured" by that industry as a result of rate-setting and license-granting functions. It was also noted that the FTC has established a good track record on telecom-related consumer protection in conjunction with the State PUCs.

Another way to "pare down" the scale and scope of FCC regulations is to first consider the types of "regulation" performed by the FCC and then to determine whether that type of regulation still needs to be continued (without reference to the agency that is best suited to perform the function). From this perspective, most members of the Committee agreed that "economic regulation" (price regulation) could be generally eliminated, leaving non-price "consumer protection" and "industry structure" regulation.

With respect to retail pricing of basic telephone service, the Committee generally felt that there is enough actual and potential competition (i.e., from UNE-P, wireless, VoIP) that basic phone service rates could be deregulated, provided that there is a strong Universal Service "safety net" to ensure that low income consumers and consumers in high cost areas are not priced off the network. If complete deregulation is "too radical," cable television rate regulation might be a prototype for telecom services: cable rate regulation has been eliminated, except for "basic" cable; analogously basic "lifeline" type of telephone service could continue to rate regulated with all other services not regulated. This would mean that remaining regulation would be focused on regulating "access" to the system.

Such "carrier-to-carrier" issues as reciprocal compensation, access charges, UNEs and UNE pricing, and performance standards consume a considerable amount of regulatory resources. It was observed that these resources could be saved if carriers were encouraged to resolve more of these complex issues themselves, through bilaterally negotiated interconnection agreements. Then, regulators would only have to arbitrate unresolved issues. It was observed that "baseball arbitration", where the arbitrator picks one party's proposal or the other's (but does no independent fact-finding and does not attempt to split the difference), could be quick and efficient.

A brief discussion of the historic "facility bottleneck" problem in telecom networks triggered a lengthy discussion about the "content bottleneck" problem which seems to be affecting cable TV operators. The cable operators are facing

substantially increased costs for the “content” (particularly sports programming) which they pass on to consumers, creating pressure for government to step in to either regulate rates or the structure of the industry (compulsory licensing, fin-syn, spectrum caps).

Cable’s problems with the cost and availability of “content” may spread to traditional telecom service providers as they attempt to “bundle” content in their broadband services. Since broadband is likely to be a significant catalyst for the overall telecom recovery, the content issues could greatly affect the speed and scale of the telecom recovery.

The Committee considered the somewhat loaded question of whether regulation should be a “meat ax” or a “scalpel” and assuming the latter is generally better, how could more precise regulation be accomplished? One observation is that current statutes are “too rigid”, effectively grid-locking policy-making into the “meat ax” approach. Similarly, it is very difficult for regulations to be tailored to the very different circumstances of each telecom market across the country. Presumably, a less rigid statute would provide regulators with a more flexible, more precise “scalpel.”

It was pointed out, however, that “meat ax” regulation would often require less time and be easier to apply than numerous “scalpel” regulations. This generated discussion about how to make the regulatory process more effective, particularly accelerating the decision-making process so that regulation would be more “in synch” with the industry. There was general agreement that the slowness of policy making and regulatory decision-making inhibits greater investor enthusiasm for the telecom sector, thus suppressing an important catalyst for recovery.

The European Market Review Process (reviewed in an FCC OPP report) was commended. European goals include: 1) elimination of historic regulatory distortions; 2) more flexibility and *ex post* regulation; and 3) application of antitrust principles regarding market entry and exit.

One suggestion for accelerating decision-making was to have telecom regulations issued by a “single decision maker” (like the “administrator” of the FAA or EPA or the Attorney General at the Department of Justice) rather than a multi-member Commission. This would be particularly true for the FCC’s (and State’s) “telecom” responsibilities, which are (or should be) “non-political” whereas Commission-type decision-making would be appropriate for the FCC’s more politically sensitive “broadcast” and “content” regulation.

With respect to fundamental guiding principles of regulation, it was generally agreed that regulation should:

- Promote innovation

- Improve the quality of life for Americans
- Reflect localism
- Encourage federalism

A related observation was that regulators can often explain and justify the “benefits” of their decision but they rarely understand the “cost”. Presumably, a “good” decision is one that is intended to produce “benefits” that exceed “costs” so that regulatory decisions would be “better” if regulators are required to assess costs as well as benefits.

The committee agreed that the bases for fundamental policies need to be revised:

- “Competition” is NOT sustainable if it is based on the outdated and now erroneous assumption that the traditional voice telephone business is stable and a foundation for all other services. The emergence of VoIP is but the latest example of the fallacy.
- Network operators cannot be excluded from value-added “content” businesses since the “network” business is not sustainable as only a commodity.
- The copper telephone loop is only “essential” for voice services, not for broadband, media and Internet applications.
- “Universal Service” has become so unmanageable that it should not be managed.

ADVISORY COMMITTEE RECOMMENDATIONS

Specific consensus (but by no means unanimous) recommendations of the Advisory Committee were:

- Deregulate retail rates (with a “safety net” mechanism to assure that all individuals have access to affordable service); regulators should NOT get enmeshed in rate “rebalancing.”
- Wholesale (i.e., carrier-carrier) relationships should also be deregulated by channeling all carrier-to-carrier issues into bilateral Interconnection Agreements that are commercially arbitrated if not negotiated and are not subject to “pick and choose” by other carriers.
- Streamline and “fix” (accelerate) the regulatory decision-making process to make regulation responsive to market realities.

- Allow the industry to reform into an economically sound structure, which will be more oligopolistic than the current unsustainable structure.
- Only “essential facilities” such as copper loops should be subject to regulation.
- Encourage broadband demand through government use of new applications.
- Rationalize taxes on telecommunications so that the telecom industry is subject only to the taxes and fees borne by other industries.
- Reform “Universal Service” because the Universal Service fees are particularly onerous taxes for the industry in its present state. The laudable goal of subsidizing low income and high cost subscribers should be accomplished through other mechanisms (i.e., current telecom excise tax?) that are less distortive.

II. MENU OF POSSIBLE RECOMMENDATIONS

From the Advisory Committee’s meetings and correspondence among the Committee’s members, a considerable number of specific recommendations were proposed for further consideration by CITI. The following is a list of some of the proposals that were submitted by Advisory Committee members and considered by CITI in reaching its “Remedies for Telecom Recovery” recommendations. The inclusion of a proposal does not imply that there was consensus support for it from the Group. Indeed, some of the recommendations are mutually exclusive. Rather, the list illustrates the broad scope of the thoughts contributed by the Advisory Committee members.

Basic Principles

1. Law and regulations must be technology-neutral.
2. Law and regulation must be service-provider-neutral.
3. Law and regulation must be geography-neutral.
4. The definition of “telecommunications services” subject to FCC and PUC regulation must be broad to accommodate inevitable technology evolution.
5. The FCC should have sole jurisdiction over the industry (i.e., preempt all state regulation)
6. A Federal statute, administered by FCC, should establish nationwide regulatory goals and principles; States should have primary authority over local and intrastate services, consistent with federal statute’s goals and principles.

7. Fund support for Universal Service through general tax revenues only.
8. Eliminate every federal, state and local tax that is telecom-specific (i.e., if it is a charge levied only on telecom companies or telecom services, it should be repealed). Similarly, eliminate every franchise fee that is telecom-specific.
9. Formally renounce cost of service based regulation on the pricing of all telecommunication (telco and cable) network elements.
10. Provide genuine equal access to last mile bottleneck facilities.
11. Service-providers offering services directly to consumers may not own or operate "bottleneck facilities," so that companies currently doing both functions must be separated. ("Bottleneck" facilities are those, such as connections to consumer premises, which cannot be functionally replicated in a reasonably commercial fashion and which are essential to the ability of other service providers' ability to offer services to their customers).

Better Procedures and Process

1. Streamline FCC to single Commissioner with a two-year term.
2. Rotate FCC Chairmanship: each Commissioner is Chair in last year of term.
3. Establish an iron-clad deadline on the resolution of telecommunications complaints.
4. For interpretation of FCC rules or US telecom statutes, provide for a prompt declaratory ruling process rather than complaint process.
5. Resolve all ILEC-CLEC arrangements (including access charges, reciprocal compensation, UNEs, performance standards) through bilaterally negotiated interconnection agreements, with any unresolved matters decided by market-specific "baseball arbitration" conducted by commercial arbitrators.
6. Require detailed reporting by telecom lobbyists of the nature and scope of *ex parte* meetings, conversations, communications, with state and federal officials and all political and charitable contributions, with penalties for noncompliance.

7. To mitigate the potential for radical shifts in policy every few years, limit the FCC Chairman's authority to putting an agenda in motion, but limiting his/her ability to shape Bureau output to that equivalent of each other Commissioner, with an explicit fiduciary obligation on Bureau Chiefs to formulate recommendations for Commissioner review based on the legal, economic, and technical merits of the record before the Commission, and having equal duty and responsibility to all Commissioners in doing so.
8. Eliminate routine regulatory reviews driven by procedural rules (e.g., biennial reviews, triennial reviews, forbearance petitions) that create unnecessary uncertainty and the potential for regulatory churn.
9. No routine review of market rules (e.g., equal access) but each new rule, going forward, can include on an individual basis triggers or timeframes for review/sunset.
10. Require FCC to meet at least twice per month.
11. With respect to each rule regulating structure or behavior of telecom companies, the FCC must state (a) why it adopted the rule, (b) what changes this rule is intended to bring about, (c) how the FCC will study whether and when those anticipated changes took place, and (d) a sunset within 5 years, with reenactment permitted ONLY IF the original predictions re changed results occurred AND the FCC documents the need to generate these results again.
12. Establish a special Article III court to hear expedited review of any contest to any new FCC rule regulating telecom. Briefs due with 30 days after rule is promulgated and oral argument a week later. Only further review is by the U.S. Supreme Court on issues of constitutional law.
13. With respect to every FCC action respecting telecom, FCC to attach to the proposed FINAL rule or decision a statement explaining why antitrust enforcement is not adequate to handle the problem and to submit rule/decision and statement to DoJ and FTC for comment. Action cannot be final and effective until 30 days after FCC receives comment. Judicial review available to consider whether FCC carried the burden of persuasion that antitrust is inadequate.

Allocating Governmental Responsibilities

1. Transfer all FCC "consumer protection" responsibility to FTC
2. Transfer all FCC "merger/industry structure" responsibilities to FTC's or U.S. Department of Justice's exclusive jurisdiction for reviewing effects of telecommunications and media mergers on competition.

3. FTC to adopt and enforce (together with state regulatory agencies) uniform strict codes of conduct and performance standards, with penalties.
4. FTC to adopt and enforce (together with state regulatory agencies) uniform strict codes of conduct and performance standards, with penalties.
5. Change FCC's mandate to be solely spectrum management. Leave both industry structure and interconnection/interoperability issues to antitrust enforcement.
6. Permit the states to enforce and remedy competition requirements, including violations concerning a federal tariff or interstate service that have a local nexus or effect (e.g., special access provisioning and pricing discrimination)
7. Give FCC independent enforcement authority (FCC rather than DoJ to seek judicial enforcement of FCC orders, penalties ,etc.)

Increasing Industry Revenue/Financial Incentives

1. Increase retail POTS rates (or decrease rate of decline) by reducing price deflators in "price cap" formulae.
2. Increase industry revenues by including automatic counter-cyclical price inflators in price cap formulae to take effect in proportion to decline of general economy.
3. Reform copyright restrictions to encourage broadband utilization.
4. Allow ILECs to purchase CLECs' unusable net operating losses (NOLs) for cash, reducing ILEC/RLEC taxes while CLECs get low cost capital infusion; CLEC could be required to use cash for facility investment.
5. Utilize government's purchasing power to achieve public policy goals such as broadband deployment, network resiliency.
6. The President should issue an Executive Order directing every Federal agency to review and eliminate barriers to use of advanced telecommunications in achieving the agency's goals. State Governors should issue a similar order to State agencies.
7. Since public safety and national security requires reliable telecom communications services, the Dept. of Homeland Security should provide financial incentives (tax certificates, loans, grants, etc.) for both ILECs and "solid" CLECs and wireless carriers which promise to operate "resilient"

networks serving residential, small business, not-for-profit, government, educational and health care institutions with low cost basic services—bundled with advanced technologies—in time of peace and crisis.

8. Public safety concerns require that telephone and perhaps text messaging, video and wireless must be available in every classroom and public meeting room and in every car, truck, van, limousine, taxi, train, subway car, motorcycle, boat sold to consumers and government; the Dept of Homeland Security should subsidize the deployment as necessary.
9. For public safety and national security reasons, the Federal government should require all citizens be equipped with a cellphone at all times (with government subsidy as required)
10. Establish loan program modeled on REA/RUS for facilities-based non-incumbent networks without geographic limits; fund with current telecom Excise Tax
11. Automatically adjust UNE-P rates in each market in accordance with HHI: TELRIC in concentrated market (HHI>1800) increasing to resale in fully unconcentrated markets (HHI<1000)
12. Raise wholesale (UNE) rates, subject to the requirement that RBOCs must set every retail rate to exceed the relevant wholesale (UNE) rate.
13. Reduce ILEC retail rates if ILECs don't invest cash flows in new facilities at historic investment levels: "use it or lose it"
14. ILECs must dividend "excess cash flow" (cash generated as the result of not investing at historic levels) to shareholders.

Reducing Industry Costs

1. Eliminate 3% Federal excise tax on local and long distance telephone service.
2. Reduce all government-imposed costs: ROW fees, spectrum fees, Gross Receipts Taxes.
3. Provide more advantageous depreciation schedules for all telecommunications capital investment (telco and cable) made subsequent to the Telecom Act of 1996.

4. Insure that existing deployed infrastructure that can be used for newly developed telecommunications is not subjected to additional fees or franchise requirements.
5. Prohibit public rights of way and pole attachment fees that recover more than actual costs and guarantee access for ancillary services.
6. Insure that interstate telecommunications is not subjected to incoherent local/state regulation or incoherent local/state taxation and fee structures.

Encouraging Broadband

1. Make a rational spectrum allocation and assignment plan the nation's top telecommunications priority.
2. Provide tax incentives for broadband investment.
3. Prohibit any tax incentives for deployment of advanced telecommunications (cable and telco services) in any areas where two or more providers of such services are already in operation.
4. Impose "open access" equipment interconnection on all broadband service (no operator restrictions on what broadband services can be used for).
5. Reclassify broadband services and facilities as private carriage arrangements not subject to common carrier regulations in Title II of the Communications Act.
6. Pre-empt state and local authority over rates, terms and conditions under which broadband information services are offered.

Changing Industry Structure

1. Structurally separate ILEC so that the outside loop plant is owned and operated by a fully separated "utility" which can only sell to service providers as a carrier's carrier. Then completely deregulate remaining retail service providers.
2. Structurally separate cable TV companies: outside distribution plant acquired by the "loop utility" which has effective monopoly on all wireline customer premises links.
3. Facilitate mergers among telecom companies to establish stable oligopoly structure.

4. When all else fails, government takeover of telecom networks mandating rates, service standards, deployment, etc: a return to monopoly stability which deals very comfortably with volatility.
5. Separate wireless companies from ILECs to ensure intermodal competition and deregulate both.
6. Provide financial and regulatory incentives (to be supervised and enforced by DOJ) for merger of energy companies with CLECs and out-of-region ILECs to create financially strong companies possessing rights-of-way, customer relationships and access to capital as well as entrepreneurial telecom experience.
7. Break former BOCs back into a separate, independent company for each State and drop every line of business restriction, including 271 and 272, on all of them.

Universal Service Reform

1. Replace the current hodge-podge of universal service charges and surcharges with a competitively neutral surcharge (comparable to 3% Federal excise tax) on all communications services that would be used exclusively to fund Federally mandated universal service programs.
2. Modify qualifications for ETC status so that support only goes to carriers that provide critical communications infrastructure and related services throughout high cost local exchange areas.

Deregulation

1. Deregulate altogether all non-lifeline telecommunications (cable and telco services).
2. On Jan. 1, 2005, the FCC should forebear from regulating wholesale and retail business service rates of any ILEC that has lot more than 20 percent of its 2001 retail or wholesale revenues from business customers to competing telecommunications service providers.
3. On Jan. 1, 2006, the FCC should forebear from regulating residential service rates of any ILEC that has lost more than 20 percent of its 2001 retail revenues from residential customers to competing telecommunications service providers.
4. Do not abandon the long-range goal of competition. Caveat: Deregulation should only follow the development of sustainable increased competition.

5. Deregulate all retail rates: there is enough competition or potential competition to protect consumers.
6. Eliminate all retail-level quality of service regulations (state and interstate).
7. Congress should mandate that, for the next 5 years, the FCC can write a new rule ONLY where necessary to replace one struck down by federal court review. Otherwise, all resources go to enforcing current rules, not to writing new ones.
8. Congress should mandate that every FCC rules have a stated sunset date, no more than 5 years in the future, together with a statement, promulgated at the same time as the rule, defining the limited circumstances that, should they occur during the next 5 years, may be used to reenact or extend the rule.
9. Adopt a bright line and granular actual competition test in product and geographic markets as the sole prerequisite for deregulation.
10. Wherever feasible, regulate only at the wholesale level to make retail competition possible and retail regulation unnecessary.

Specific Regulatory Decisions/Policies

1. End UNE-P on a date certain.
2. Set a date-certain for elimination of UNE-P regime in order to encourage facilities-based competition.
3. All wireless carriers to implement and to recover the cost of local number portability over a 24 month period beginning in 2004 through an explicit charge on the end users' monthly bill.
4. UNE-P should only be available in States where retail rates are deregulated.
5. Unless carriers negotiate a different arrangement, apply "bill and keep" to all local reciprocal compensation.
6. Complete access charge reform by reducing inter-carrier compensation, eventually getting to "bill and keep", over a 3 year transition period that would commence with the completion of the current CALLS agreement in July 2005.
7. Enact Universal Bill and Keep for all telecomm interconnection, as in OPP and Common Carrier Bureau papers.

8. Unless otherwise negotiated by carriers, make all inter-carrier compensation between service providers uniform and equal to economic costs, regardless of the “type” of provider or service (e.g., CMRS, LEEC, IXC, ISP; UNE, special access, local interconnection, etc.)

Circumstantial Regulation: Dynamic Regulation for a Dynamic Industry

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*NOTE: This essay reflects the views of the author;
it was not reviewed by the Advisory Committee*

To be effective, telecommunications regulation must be “in synch” with the state of the telecom industry: regulations should conform to the real-world circumstances of each market so that highly competitive markets would have little or no regulation and markets without the prospect of competition would presumably have more intense regulation. And since telecom is a dynamic (and possibly unstable) industry, regulations applied in each market would have to continuously adapt to the inevitable changes in each market’s circumstances. Such an effective regulatory system could be characterized as “circumstantial regulation.”

What we have today is far from this ideal: rather than “circumstantial” regulation, we have “static” regulation where the regulatory system attempts to apply the same regulations to every market without regard to the vastly different real-world circumstances of each market. At best, such a static system, will produce sub-optimal results in almost every market and, at worst, it will become so gridlocked that actual harm is done to consumers and the industry.

Unfortunately, the Telecom Act of 1996 made regulation less circumstantial and much more static by centralizing too much authority in the FCC, by taking responsibility away from the individual states and by micromanaging so much that the regulators, state and federal, could not react to unexpected events, such as the Internet “boom” and the telecom “bust.”

Simply eliminating all regulation can’t eliminate static regulation: while the current circumstances of some markets clearly justify complete deregulation, the real-world circumstances of other markets require substantial regulation.

Described broadly below are three things that can be done to make the regulatory system more circumstantial and less static. These three recommendations share a common theme: wherever possible, regulators should allow or promote experiments so that all stakeholders can confidently and quickly make decisions that are based, as much as possible, on observed results rather than on paralyzing speculations about the future.

Recommendation 1: Use the States as laboratories, particularly on local telecom issues, to develop quickly low-risk policies that are more attuned to the real-world circumstances of each market.

Experiments (or even “muddling through”) at the state level are a dynamic, low-risk way of determining which regulatory policies work and which do not. Instead of trying to predict the future through protracted, bitter and often pointless paper proceedings that are then gridlocked by interminable judicial proceedings, the FCC should simply observe what worked and what didn’t work in a variety of States before committing the entire nation to a particular course. Managers, investors and other stakeholders could observe the same experiments and continuously adjust their expectations and plans based on those real-world observations. With more circumstantial regulation, the certainty, predictability and risk containment valued by investors and managers would increase.

The development and subsequent destruction of local telecom competition illustrates the benefits of circumstantial regulation and the corrosive impact of static regulation. Local telecom competition was successfully introduced through a series of continuous State circumstance-specific “experiments” which began in 1985, not by the Telecom Act of 1996 or any FCC policy. Indeed, a good argument can be made that the Telecom Act planted the seeds of the recent “meltdown” of local competition and the downturn was made worse by the inability of regulators to react nimbly because of the gridlock created by the Telecom Act’s micromanagement.

Recommendation 2: Deregulate all retail rates and then only re-regulate in markets where it is clear that competition and potential competition have been unable to protect consumers from abuse.

Where rate regulation for telecom services such as long distance and most business services has been eliminated, there has been no obvious “rate gouging” or other sorts of consumer abuses. Now, with the wide availability of unregulated wireless phones, the advent of aggressive UNE-P based wireline competition, and the imminent widespread availability of unregulated “voice over IP” (VoIP) telephone service, at least a few States should take the opportunity (and have the courage) to deregulate all retail rates to learn what happens.

It is likely that not much would happen in most markets. However, the State “experiments” would also illustrate why, when and how retail rate regulation should be re-imposed when there is evidence that competition in a particular market (including potential competition) is not adequate to prevent unreasonable rates. With a proper universal service subsidy system, there would be no concern that consumers would not be able to afford basic services while these experiments are being conducted.

Recommendation 3: Resolve all carrier-to-carrier issues through negotiation and fast, inexpensive “baseball” arbitration, not endless regulatory gaming.

Most of the issues that are gridlocking the FCC and the industry while destroying investor confidence (such as UNEs and UNE pricing, collocation, reciprocal compensation, access charges, performance standards and penalties) are really “business issues” that can and should be determined by the negotiation and arbitration process established by sec. 252 of the Telecom Act. Regulators should not be deciding business issues for the carriers.

With a functioning interconnection agreement process, there would be no need for endless speculation about whether UNE-P is good, bad or indifferent for a particular carrier in a particular market or whether “bill & keep” is a better reciprocal compensation system. The real-world results of a variety of interconnection agreements – the results of experiments -- would speak for themselves.

State Commissions should use only experienced commercial arbitrators (and certainly not PUC employees) to conduct “baseball arbitration,” where one side wins all the disputed issues and the other loses every issue. The commercial arbitrators would be guided by standards of commercial reasonableness, the Communications Act and FCC regulations interpreting the Act (i.e., the FCC’s determination of what “necessary” and “impair” with respect to UNEs).

Baseball arbitration forces parties to be reasonable and to negotiate toward the middle rather than taking extreme positions in the expectation that an arbitrator will “split the difference.” Baseball arbitration will be quick (generally a few hours, at most) and therefore inexpensive: the arbitrator will not do any independent fact-finding or attempt to find a middle ground and if the parties fail to settle, the arbitrator will simply select the most reasonable proposal that is consistent with the law. For due process reasons, the PUC will have to review and adopt the arbitrator’s decision. The PUC should only reject the arbitrator’s decision if it is patently unreasonable or incompatible with the law, in which case the PUC would send the issue back to another arbitrator.

Any agreements, negotiated or arbitrated, should only be subject to “opt in” by other parties, not “pick & choose” to encourage real bargaining and to ensure that there are a substantial variety of experiments.

Finally, the geographic scope of arbitrated (but not negotiated) agreements should be limited to relatively small areas -- perhaps as small as exchange areas—to minimize the adverse impact of a “bad” arbitration decision and so that there will be many different arbitrated arrangements within a State and even between the same two carriers. Each of these different arrangements will be an “experiment,” the result of which can be fed back into private carrier-to-carrier negotiations. The experimental results will also be applied to subsequent negotiations, arbitrations and the few regulatory decisions that still might be needed.

In summary, today’s static regulatory system is simply incompatible with a dynamic telecom industry. The same regulation cannot be effective over the wildly different sets of circumstances that characterize each telecom market across the United States. Rather than continuing the paralysis that has resulted from trying to predict the unpredictable, regulators, the industry, investors and consumers would be much better served by relatively small-scale, continuous “experimentation,” the more localized, the better. Good experimental results will be quickly emulated and “bad” ones will not be repeated.