Regulatory & Policy Recommendations

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Abstract – The role of regulation as a significant contributing factor in the telecom downturn is unclear, but probably relatively minor compared to other factors. However, government policies could accelerate the recovery in the United States. Unfortunately, the regulatory decision-making process is so “gridlocked” that the first priority has to be reforming regulatory process so that beneficial substantive decisions can eventually be made. One reform would be to minimize the scale and scope of regulation to only those functions that are demonstrably necessary to consumers’ welfare. Other reforms include streamlining and experimentation. Some of these improvements may require new laws. Rather than tinkering with further amendments to the Communications Act of 1934, Congress should start over with a simple telecom statute that establishes clear principles and goals and leaves implementation details to Federal and State regulators.

1. UPDATE FROM 2003

In the past year (since CITI’s Remedies for Telecom Recovery conference in October 2003), the greatest change in the telecommunications legal and regulatory environment has been a growing call for an overhaul of the basic telecommunications law of the United States (the Communications Act of 1934, as amended). While new laws or the prospect of long legislative uncertainty may have adverse consequences for telecom recovery, CITI will nevertheless recommend statutory changes in the context of the overall “Remedies for Telecom Recovery” project:

SUBJECT TO REVISION PRIOR TO PUBLICATION
• In the nearterm, what changes in the statute would encourage telecom recovery?

• What changes could slow the recovery or even make it worse?

• Looking further ahead, what changes might set the stage for a subsequent industry downturn?

• What changes might delay or minimize future downturns?

This chapter will take the regulatory and policy recommendations made by CITI in October 2003, update the recommendations in light of developments in the past year, and suggest how the basic telecom law could be amended or rewritten to adopt the revised recommendations.

2. SUMMARY AND UPDATE OF ADVISORY COMMITTEE VIEWS

With respect to the role of regulatory policy as a cause of the telecom meltdown, in October 2003 the strong consensus of the CITI’s Advisory Committee on Regulatory Policy was that regulation and regulatory policies were NOT major contributing factors. One basis for this view is that the downturn was similar throughout the world even though the kind and degree of regulation varied greatly in each country. Rather, the regulatory experts assigned much greater blame for the downturn to the financial community’s (and particularly institutional investors’) fundamentally flawed analysis of the future direction of the basic telecom business. (Interestingly, the project’s Finance Advisory Committee experts seemed to ascribe more importance to regulatory factors than did the regulatory experts.)

From the regulatory experts’ perspective, the telecom “boom” was the result of investors expecting telecom to evolve into more of a value-added, higher margin, less regulated business in the “Internet Age” and, conversely, to be less of a commodity, low margin, regulated business. Investors expected that fast-growing, value-added Internet-oriented businesses (i.e., WorldCom, Global Crossing) would be unregulated or at least substantially less regulated and that the
traditional regulated utility businesses would gradually fade to relative irrelevance. With this expectation, analysts and investors simply paid less attention to regulation and government policy during the “boom” as their (mis)perception of the expected value-added nature of the business grew.

From this perspective, the “bust” in investor sentiment was inevitable once it became apparent that most Internet value would be captured outside the core telecom networks and that telecom services—even IP based--were likely to remain commodity businesses. Telecom valuations based on expectations of capturing substantial Internet value were irrational and unsustainable.

Now that the bubble has burst, telecom is expected to continue as a highly “commoditized”capital-intensive business for the foreseeable future and regulation is once again regarded as a critical factor by investors. Thus, while regulation and regulatory policy might not have been significant factors in causing the downturn, they are likely to be important factors—for better or for worse -- in any recovery.

According to the Advisory Committee experts, regulation will affect “recovery” of the telecom sector in these ways:

- Regulation places claims on corporate earnings and those claims can inhibit recovery if they become relatively significant, which is the case when other industry fundamentals are weak. However deregulation won’t automatically help the overall telecom industry, just as deregulation didn’t make all airlines successful.

- Sustained recovery (presumably the best sort of recovery) implies some sort of sustainable industry structure. How much competition is sustainable and will government policy encourage/support/allow a sustainable (presumably lower) level of competition?
• If fundamental economics are allowed to determine industry structure, the likelihood is that the industry will have fewer major players (perhaps as few as three). But will government allow this degree of consolidation?

• “Regulatory uncertainty” that results when a regulatory issue is undecided for a long time is usually worse than the “wrong” regulatory decision for investor confidence, which is a key to recovery. So, faster, clearer decisions are better than “perfect” decisions that take too long.

• “Regulatory certainty” is unattainable: every law, rule and policy can be changed by statute, agency action or court decision. Elections, appointments, retirements, the luck of the draw and many other factors also provide the opportunity for change and therefore uncertainty. Moreover, one investor’s dreaded “uncertainty” can be another’s “opportunity” so certainty isn’t necessarily desirable.

• Some regulatory experts believe that the success of the wireless industry demonstrates that “correct” government policies (i.e., spectrum availability, minimal retail price regulations, favorable interconnection prices, etc. in the case of wireless) could encourage recovery. Other experts disagree and point out that wireless (and the largely deregulated DSL service) are not covering their cost of capital so there is no meaningful correlation between financial performance, good or bad, and the degree of regulation or deregulation.

The initial consensus (but by no means unanimous) recommendations of the Advisory Committee’s experts were:

• Deregulate all 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

• Deregulate wholesale (i.e., carrier-carrier) arrangements by channeling all carrier-to-carrier issues into bilateral
Interconnection Agreements that are commercially arbitrated if bilateral negotiations fail. The resulting agreements should only be subject to an “opt in” (rather than “pick and choose”) by other carriers.

- Streamline and “fix” (accelerate) the regulatory decision-making process to make regulation more responsive to fast-changing market realities.

- Allow the industry to reform into an economically sound structure which, in the nearterm, is likely to be more oligopolistic than the current unsustainable structure.

- Subject only “essential facilities” (such a copper loops) to regulation.

- Encourage broadband demand through government use of new applications.

- Don’t make regulatory distinctions on the basis of technology (technology neutrality)

- 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 depressed 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.

Developments since October 2003 provide no basis for changing these recommendations one year later; rather, developments during the past year validate them.
3. **Fundamental Problem for Recovery Is That the Gridlocked Regulatory Process Paralyses Management and Investors**

One of the great problems and challenges facing policymakers and the telecom industry is how major government policies and regulations can be changed rapidly to stay in step with the rapid, unpredictable changes of a volatile and fundamentally unstable telecom industry. Managers, investors and users need to know quickly and with reasonable assurance what the government’s rules and policies are going to be so that they can then adapt their activities accordingly.

By contrast, if management and investors don’t know what the basic rules are, there will be a natural tendency—exacerbated by the meltdown—to hesitate and to wait until the rules get clearer. Therefore, once an important issue is “teed up” on the government agenda, the substance of the subsequent decision may be less important than the speed at which a reasonably final decision can be reached.

Some changes in the substance of various government policies could have a significant impact on the telecom recovery. Indeed, the experts in CITI’s Finance and Management Advisory Committees suggested that a number of government actions would be beneficial. However, CITI’s regulatory experts saw little chance that any substantive changes could be adopted in a timeframe that could aid the recovery because of the decision-making “gridlock.” The experts suggested three reasons for this gridlock:

- First, the telecom industry itself has been torn into fractious and competing segments that are so inordinately suspicious of each other that any change thought to benefit one segment will be ferociously opposed by that segment’s competitors. In most legislative or regulatory proceedings, it is much easier to block a change than to make a change. The result is that the industry has “gridlocked” the public policy process.
• Second, many policy changes that might benefit the telecom industry financially are likely to be at the expense of consumers. This is particularly true with respect to remedies that reduce competition and/or increase retail prices. Consumers have benefited greatly during both the “boom” and “bust” of the telecom industry and it will be difficult to convince regulators or legislators that there is a need to make changes that disadvantage consumers simply to help multi-billion dollar companies.

• Finally, even without industry and consumer interests blocking changes, the Constitutionally required “due process” of changing fundamental law or regulations (including seemingly inevitable litigation) is slow, ponderous and uncertain.

The 1996 amendment of the Communications Act seems to be a cause of the gridlock. For all its well-meaning intentions about loosening the grip of government, the Telecommunications Act of 1996 ended up centralizing all fundamental telecommunications policy in the FCC, effectively federalizing the 50 states with respect to local competition and preempting the judicially-supervised modified final judgment (MFJ) with respect to Bell entry into long distance. Among other objectives, this centralization was intended to satisfy investors’ alleged desire greater “certainty” and “predictability”.

However, the Telecom Act did not simply establish broad policy goals – such as competition in all markets and less regulation – and then leave it to the FCC to achieve them. Rather, the statute itself sought to micromanage the implementation of specific regulatory policies by, for example:

• setting the FCC’s work schedule by imposing numerous implementation and decisional deadlines;
• specifying three pricing methodologies for ILEC-CLEC interconnection;
• establishing nebulous concepts such as “necessary” and “impair” as decisional standards for determining when ILECs are required
to offer unbundled network elements (UNEs);
• constructing a detailed system for negotiating, mediating and arbitrating interconnection agreements, with substantial regulatory involvement in the arbitration process; and,
• specifying a 14-point checklist to be satisfied before a Bell could offer long distance services.

This statutory micromanagement, in turn, has led to:

• seven years (1996-2003) required for Bell company entry into long distance services;
• eight years (and counting) related to unbundling network elements to facilitate local entry; and,
• the continued existence of implicit subsidies in telecom rates, despite the Telecom Act’s directive to eliminate them.

There is nothing substantively wrong with the policies imposed by the Telecom Act except that they took away much of the flexibility of the implementing agency – the FCC—to adjust policies later in light of unexpected or changed circumstances. Two huge changes in fundamental circumstances not anticipated by the Telecom Act were the rapid development of the Internet and the monumental “bust” in telecom investors’ confidence.

Looking ahead, the process of trying to decide whether and how to regulate “Voice over Internet Protocol” (VoIP) is likely to be gridlocked even though the decision will have profound impact on the future of the telecom industry.

During 2004, the nature of the long standing ILEC-IXC-CLEC conflicts that caused so much gridlock may have changed as the long distance carriers and CLECs have been substantially weakened, providing them less ability to check (gridlock) the stronger ILECs’ regulatory initiatives. However, the cable industry—which has more direct relationships with consumers (voters) than IXCs or CLECs-- is likely to become the principal political counterweight to the ILECs.
In the absence of a crisis that seriously affects consumers (such as frequent and massive service outages) and within the existing statutory framework, CITI’s regulatory experts believe that it will be virtually impossible for legislators or regulators to adopt substantive remedies that would have a meaningful near-term (2005-06) effect on recovery.

It is important to note the “in the absence of a crisis” proviso. If the quality, reliability and capability of the basic national telecommunications infrastructure were to deteriorate, government policies could be changed quite quickly. Of course, hoping for a major infrastructure crisis to break the regulatory gridlock is akin to a doctor prescribing radical surgery that is likely to kill the patient.

It is also important to note that the experts’ forecast of continued gridlock assumed the existing statutory framework. Therein lies a glimmer of hope: a potentially important development during 2004 has been a growing chorus of dissatisfaction with the Communications Act. This dissatisfaction raises the possibility that a new gridlock-breaking and gridlock-avoiding law could be considered during 2005 and be enacted during 2006. Presumably, a new statutory framework that wasn’t doomed to be gridlocked in Congress would have to be simple and not be a means for embedding one industry segment’s agenda in law. The last section of this chapter outlines such a simple statutory framework.

4. **Reducing Regulatory Gridlock Should Be a Primary Means for Encouraging Telecom Recovery**

If “gridlock” is a substantial obstacle to government actions that could be remedies for telecom recovery, what are the remedies for gridlock? There are two obvious ways to eliminate or substantially reduce regulatory gridlock:

1. **Minimize the opportunity for gridlock in the first place by reducing the overall scale, scope and complexity of**
regulation. This will result in fewer, simpler decisions that can be made more quickly and scarce regulatory resources can be focused on fewer, better (i.e., more sustainable in appeals to courts) decisions.

2. **Streamlining the regulatory process** so that once a matter gets on to the policy and regulatory agenda, it will be decided as quickly as possible.

Some aspects of these solutions may require substantial changes in the federal Communications Act and State public utility statutes and are therefore more problematic. However, many process and procedural changes are within the control of the regulatory agencies themselves so rapid self-reform would be feasible.

### 4.1. REDUCE GRIDLOCK BY ADOPTING AND FOLLOWING GUIDING PRINCIPLES AND POLICIES

One way to reduce gridlock is to minimize the tendency for regulators to spread their resources too thinly by becoming entangled in perhaps interesting but nevertheless non-essential matters. In the absence of legislative mandates, regulators should only address matters which were consistent with their set of fundamental guiding principles. Articulating and then adhering to a small number of fundamental principles will make regulatory decision-making quicker, more consistent and more predictable, which in turn will engender investor confidence and minimize the likelihood or success of appellate litigation.

Fundamental principles (including those suggested by the Advisory Committee in 2003) might include, for example:

- Competition is to be preferred in every market to encourage fair prices, innovation and efficiency.
• In markets where competition is demonstrably insufficient, regulation should be applied to the minimum extent required to protect consumers from pricing and service abuses.

• The allocation of regulatory authority and responsibility between States and the Federal government should be based not on the increasingly unknowable “jurisdiction” of the traffic but on the basis of which agency is best positioned and equipped to handle each specific regulatory responsibility.

• Policies based on the outdated and now erroneous assumption that the traditional voice telephone business is stable and a foundation for all other services will not be sustainable. The emergence of VoIP is but the latest example of the fallacy.

• No industry structure can be assumed to be stable or permanent: sustainable policies must be able to accommodate substantial changes in industry structures, ranging from multiple competitive infrastructures to duopoly and even monopoly.

• A competitive “infrastructure” business may not be economically sustainable if limited to providing only commodity transport services, so network operators may need to offer value-added “content.”

• Only “essential facilities” need to be regulated. Currently, the copper telephone loop is an “essential” facility for circuit-
switched voice-grade services, not for broadband, media and Internet applications. This loop will become less essential and then non-essential as broadband services and wireless become widespread alternatives to POTS.

- “Universal Service” has become so unmanageable that it should not be managed by regulators.

4.2. REDUCE GRIDLOCK (AND INCREASE EFFECTIVENESS OF REGULATION) BY ENCOURAGING SELF-REGULATION THROUGH STRONG ENFORCEMENT WITH MEANINGFUL PENALTIES

There would be less need for regulation, particularly with respect to enforcement, if the industry was able to self-regulate and if the prospect of severe penalties encouraged better behavior.

4.2.1. LARGER FINES, IMPOSED FASTER

Fines and forfeitures, however denominated, can encourage self-regulation if the amount of potential fines is so large that it will have an obvious deterrent effect. (By contrast, if the potential fine is too small, the fine may be treated as a license fee or a cost of doing business.) The FCC has been seeking authority from Congress to impose significantly higher forfeitures for this reason. Fines that are a percentage of revenue or net income rather than a maximum forfeiture per event might be more effective since the impact would be essentially the same for large and small companies.

To be an effective deterrent and to encourage behavior which doesn’t require regulatory intervention, the fines must be applied swiftly. Using Administrative Law Judges to hear cases and recommend fines would be more effective than the “paper proceedings” currently utilized by the FCC. In addition, appellate courts are more likely to sustain substantial penalties assessed in a contested, open trial-type of proceeding than the closed and opaque procedure currently used by the FCC.
4.2.2. **LOSS OF OPERATING LICENSES SHOULD BE POSSIBLE CORPORATE PENALTY**

It is well known that the FCC issues spectrum licenses to carriers for use of the public airwaves. But less well known is that every telecommunications services carrier holds a “Sec. 214” operating authorization. Once issued on a case-by-case basis, Sec. 214 authorizations are now conferred on an automatic “blanket” basis to any company that offers interstate service. Similarly, most States require providers of intrastate services to hold a “certificate of public convenience and necessity” (or something similarly worded).

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<td><strong>Loss of Licenses</strong></td>
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<tr>
<td>• License implies government acceptance, and is relied upon by investors, customers, business partners</td>
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<td>– A license requires “good character” and “fair dealing”</td>
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<td>– FCC has revoked licenses for consumer fraud (“slamming &amp; cramming”) and mis-statements (RKO’s broadcast licenses)</td>
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<tr>
<td>• If all employees and investors understand that corporate behavior may lead to loss of licenses, they will be more interested in the company’s compliance and ethical behavior</td>
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The FCC “Sec. 214 authorization” and most States’ CPCNs are routinely granted and impose little or no procedural burden on regulatory agencies and few costs on the holder. Rather than a means for regulating market entry, nowadays the principal purpose of these licenses is to give the regulators an enforcement “hook” on carriers. For example, the FCC routinely uses revocation of Sec. 214 authorization to halt abusive practices by carriers such as “slamming” and “cramming.”

The FCC (and the States) could do much more with the license revocation authority to help telecom recovery. For example, if the FCC routinely revokes licenses of carriers that engage in consumer
fraud through so-called “slamming” and “cramming,” why shouldn’t it revoke the license of carriers that engage in systematic, deceptive practices that defraud investors? By making it clear that it would, the FCC would reduce the incentive for such deceptive practices and provide a motivation for the management, employees and investors of a licensee to not tolerate them.

The relationship between licensing and bankruptcy deserves some attention in the context of telecom recovery. It is alleged that the bankruptcy of one carrier and its reemergence from bankruptcy with a substantially lower cost structure dooms its competitors to their own bankruptcies and the industry to a never ending cycle of serial bankruptcy. Of course, the prospect of serial bankruptcy destroys investor confidence in the sector. Should bankrupt telecom companies continue to hold licenses? Should restructured bankrupt service providers automatically hold operating licenses? Can bankruptcy courts require regulators to issue and maintain the licenses of bankruptcy?

### 4.2.3. **Bar Disgraced Managers from Employment with Licensees**

The Securities and Exchange Commission can bar “bad actors” from the securities industry and consent agreements to that effect are common. Why can’t the FCC have similar authority? For example, where an operating license is revoked for bad behavior, the FCC should have the ability, after appropriate due process, to prohibit other licensees from employing individuals found responsible for the bad behavior.

The possibility of being barred from the industry would provide managers with strong personal reason for not engaging in bad behavior. And this would make it more difficult for managers to engage in “serial fraud” by creating a new company every time the FCC revokes an operating license.
4.2.4. ENCOURAGE INDUSTRY COOPERATION AND CODES OF CONDUCT

Over the years, government agencies, including regulators, have become involved in a wide number of operational matters that could be handled, in the future, through industry organizations or industry codes of conduct with less or no government oversight. Minimizing government involvement in operational matters would have two benefits. First, the speed of decision-making would less dependent on notoriously slow government processes. Second, government would have less responsibility for the substance of the decisions, meaning that it can be more aggressive in enforcement and oversight.

Regulatory agencies could encourage the development of cooperative industry activity or codes of conduct which would also contribute to recovery include:

- Uniform accounting standards and practices (such as what constitutes revenue and how to treat Indefeasible Rights of Use) to minimize fraud, increase transparency and investor confidence.
- Common OSS, billing and IT standards and interfaces to streamline operations within a “network of networks” and minimize disputes over ordering, maintenance and billing.

4.3. REDUCE GRIDLOCK BY DEREGULATING RETAIL SERVICES

One obvious gridlock-causing “sticking point” is the regulation of retail rates and service quality. Historically, State public utility commissions regulated basic local telephone services for two reasons: 1) to prevent abusive pricing of essential services by monopoly suppliers; and, 2) to make basic service more affordable in high cost areas and to residential consumers through an elaborate system of cross-subsidies.

Both rationales are artifacts of the monopoly era; neither is
appropriate in today’s more competitive environment. The elaborate rate proceedings themselves can cause uncertainty for considerable periods of time and are massive drains on regulatory resources. But just as importantly, the social subsidy “ripple effects” of rate regulation, such as Universal Service and access charges, create their own gridlock and uncertainty.

If a market is reasonably competitive, there would be no consumer protection justification for retail service regulation. This principle has worked well in the long distance market: once there as enough competition from MCI, Sprint and others so that AT&T was determined to be “non-dominant,” the FCC eliminated retail price regulation of long distance services. Similarly, prices of wireless telephone services are not regulated since no cellular carrier has been able to dominate that market.

CITI believes that there is sufficient actual and potential competition for every retail telecommunications service, including basic local telephone service, to justify deregulation. Basic telephone service consumers in most (but not all) geographic markets now have reasonable alternatives to the traditional local exchange carrier (ILEC) from wireline resellers, numerous wireless services providers and, increasingly, from VoIP provided over telco and cable broadband services. (While competitive alternatives from carriers using the UNE-Platform will fade beginning in mid-2004, consumers’ opportunity for having “IP Telephone” (or VoIP) service from cable TV companies as well as from independent IP Telephone service

OCT. 2003 CONFERENCE

**Deregulate Retail Prices**

- Immediately deregulate all retail prices
  - Retail markets disciplined by:
    - Wholesale arrangements (UNE-P/resale)
    - Wireless
    - VoIP
- Re-impose price regulation only in markets where actual/potential competition is demonstrably unable to discipline
- Use Universal Services subsidies, not retail and wholesale price manipulations, to keep low income/high cost consumers on network
providers such as Vonage is increasing rapidly.) Therefore, it is difficult to imagine that ILECs could abuse their customers by raising prices or offering poorer quality service without suffering substantial competitive losses.

Of course, there will be a few geographic markets where there is insufficient competition to protect consumers from abuse. Consistent with the goal of de-gridlocking the regulatory process, CITI does not recommend hundreds or possibly thousands of market-by-market deregulation proceedings. Each local market proceeding would be an opportunity for gridlock and the entire regulatory system would grind to a halt. Rather, it would be better to “flash cut” retail rate deregulation in ALL markets and then observe whether and where any abuse of consumers actually occurs. There are plenty of competitors and consumer advocates to bring any suspected abuse to state and federal regulators’ attention. Where consumer abuse is demonstrable, swift re-regulation would be appropriate and necessary.

Since local, intrastate POTS is currently regulated by each State, Federal preemption of State regulation, presumably through Federal legislation, would be required to assure retail rate deregulation on a national basis. Such legislation should empower the FCC, in consultation with the States, to determine a “flash cut” date within one year of enactment and establish the criteria that would justify re-regulation in particular markets. State Commissions would then be responsible for applying the FCC’s re-regulation criteria and the FCC would hear any appeals of a State’s decision to re-regulate.

In the absence of Federal legislation, or perhaps as “experiments” to justify a national policy (see 4.5, below, for discussion regarding experimentation) some States could implement retail rate deregulation by the decision of the State’s regulatory commission under existing State law. In other States, legislation would be required to de-regulate or give State Commission’s the authority to deregulate.

Since retail rate regulation is one means for artificially keeping basic service rates below cost in some markets and for favored classes of
consumers, abolition of retail rate regulation would mean that Universal Service objectives would have to be achieved by means other than implicit cross-subsidies. This would be consistent with the stated but thus-far-ignored Congressional mandate of eliminating such implicit subsidies.

If complete retail rate deregulation is “too radical” and would itself cause more “gridlock,” the regulation of cable television rates might provide a less radical model. Cable rate regulation has been eliminated, except for “basic” cable, with remaining regulation focused on regulating “access” to the cable television system. Analogously, only basic “lifeline” telephone service would be rate-regulated.

4.4. REDUCE GRIDLOCK BY RESOLVING ALL CARRIER-TO-CARRIER ISSUES ONLY THROUGH INTERCONNECTION AGREEMENTS AND COMMERCIAL ARBITRATION, NEVER BY REGULATORS

A major source of regulatory “gridlock” is related to the resolution of “carrier-to-carrier” business issues, including: reciprocal compensation; access charges; UNEs and UNE pricing; and, performance standards. Not only do these matters consume much of the resources at regulatory agencies, they pit industry sectors and companies against each other, with the usual result that each side neutralizes the other so that little “progress” is made despite prodigious exertion.

Resources could be saved and the issues removed almost entirely from the regulatory process if service providers

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<tr>
<td><strong>Interconnection Agreements for All Carrier-to-Carrier Matters</strong></td>
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<tr>
<td>- Bilateral agreements, not regulatory intervention, must be the primary vehicle for establishing all carrier-to-carrier arrangements</td>
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<tr>
<td>- UNEs, Reciprocal Compensation, Access Charges, Performance Stds, etc.</td>
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<tr>
<td>- Binding “baseball” arbitration by State-appointed commercial arbitrators in absence of voluntary agreement</td>
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<tr>
<td>- Granular, market-specific arbitrations</td>
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had to resolve all of these complex business issues themselves, through bilaterally negotiated interconnection agreements. Then, at most, regulators would only have to be involved in unresolved issues.

Under sec. 252 of the Telecom Act, if carriers can’t negotiate interconnection agreements, they are entitled to have state regulators arbitrate the dispute. However, to avoid the gridlock that normally occurs in a contested regulatory proceeding, regulators should by appoint experienced commercial arbitrators to conduct the arbitration. This is appropriate: these are business deals not regulatory proceedings so it would be best to let people experienced in business matters make the decision.

Additionally, unless the parties to the arbitration agree on some other procedure, the default arbitration process should be “baseball arbitration,” where the arbitrator can only choose between the parties’ final package of offers: one side will win all the disputed issues and the other side will lose on every issue. The prospect of “baseball arbitration” should raise the risk to both parties and force both parties to be reasonable (approach the “middle”) in their final offers since the arbitrator will generally choose the “most reasonable” offer.

The use of private, experienced and expert commercial arbitrators will speed the process, lower the cost and reduce regulatory gaming because the State regulators’ role in the resolution of specific disputes will be limited to reviewing and either adopting or rejecting the arbitrator’s decision. That does NOT mean that regulators and regulatory policy wouldn’t be involved in “wholesale” arrangements between carriers. But instead of becoming entangled in the resolution of specific disputes, regulatory policies and objectives should be incorporated into the arbitration standards to be utilized by the commercial arbitrator. Indeed, by knowing what the arbitration standards are, parties would be able to predict with reasonable certainty what the arbitrator’s decision would be, making it less likely that there would be significant unresolved issues to arbitrated.
Consistent with the idea of reducing gridlock, arbitration standards should be a set of a few simple policy goals, such as maximizing:

- network interconnectivity
- economic efficiency
- retail competition
- consumer benefits, and
- network reliability

But the essential charge to the arbitrator is to pick the most commercially sensible result.

If the State Commission rejects the arbitrator’s decision as being incompatible with the arbitration standards or the law, it would NOT try to insert its judgment and rewrite the decision. That would be a gridlock inducing step. Rather, the State Commission would send the issue back to another arbitrator with an explanation of why it rejected the earlier decision. If the State rejects the commercial arbitrators’ recommendations three times, to avoid further delay and gridlock, subsequent arbitration recommendations would be considered by the FCC.

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

By “fixing” the interconnection agreement process, there would be no need for endless speculation about whether UNE-P is good, bad or indifferent or whether “bill & keep” is a better access charge or reciprocal compensation system. The real-world results of a variety of interconnection agreements – the results of private, commercial experiments -- would speak for themselves. The real-world experience can then be applied to subsequent negotiations, arbitrations and the few regulatory decisions that still might be needed.
Even though regulators would not be involved in carrier-to-carrier issues, it is important to note that anticompetitive behavior by one carrier (such as leveraging bottleneck facilities) would be subject to private antitrust action and antitrust enforcement by the US Department of Justice and State Attorney Generals.

4.5. **REDUCE GRIDLOCK BY DEVELOPING BETTER EVIDENCE THROUGH EXPERIMENTS (OR PROMOTING “CIRCUMSTANTIAL REGULATION”)**

Better evidence makes better decisions. This truism applies as well to telecom decisions as any other. So, what is the best evidence for telecom decision-making?

Much of the regulatory gridlock can be attributed to the “dueling” theories, studies and experts submitted by opposing parties as evidence in an attempt to “prove” the future. This “hypothetical evidence” leaves the regulators—particularly the FCC—in the position of picking and choosing from this “evidence” whatever supports the policy outcome they prefer. This is risky decision-making and subject to endless appeals because it looks (and inevitably is) arbitrary and capricious.

Experimental evidence (as compared with hypothetical evidence) would be more reliable and of much higher quality, making resulting decisions both less risky and more sustainable.

To illustrate the value of experimentation to investors and regulators, consider local telecom competition. With respect to local competition, it is important to recognize that the Telecom Act of 1996 was neither revolutionary nor innovative. Rather, the Act largely codified into national law and policy the results of many local competition experiments that had been conducted by State public utility commissions since 1985.

Many observers claim that this state-by-state experimentation – with its admittedly untidy look of “muddling through”—did not provide
the “certainty” and “predictability” sought by investors. Ironically and not appreciated by investors at the time and perhaps even today, “muddling through” was and is much less risky than a single federal policy, particularly when the federal system gets “gridlocked” in interminable due process. That is because “muddling through” in the States allowed for a continuous and low-risk iterative process of field experimentation, testing, and fine tuning of business strategies and public policies before irrevocable, major investment bets are placed on a national scale. Historically, when State experiments were deemed to be “successful,” other States and then the FCC made similar decisions. But when State experiments were judged to have “failed,” they were rarely repeated by other States and did not become national policy under the FCC.

Unfortunately, the Telecom Act stopped the state-by-state experimentation and did not empower or encourage the FCC to undertake its own experiments. Instead, every major regulatory issue has become a single high-risk roll of the dice. Now, every FCC decision—because it has such far-reaching application—literally becomes a multi-year “federal case” and leads not to finality but to litigation, with fundamental decisions being made not by an expert agency but by judges and their law clerks. While all this is going on, many business plans are paralyzed. This sort of gridlock cannot engender investor confidence.

The FCC should use the States as laboratories, particularly on matters where the decision should be tailored to local circumstances. As they did in the past, a few States will make decisions that the FCC will regard as “good” and a few others will make “poor” decisions. Then it is likely that other States will copy and improve the “good” results and, when the evidence is clear and convincing, the FCC can quickly and confidently make national policy based on real-world experimental evidence (the best evidence) rather than warring studies and sheer speculation about the future (the worst evidence)...no more risky rolls of the regulatory dice.

In addition to producing better evidence, experimentation will allow a regulatory system to be more “in synch” with the industry it regulates.
An ideal regulatory system will impose regulations only when and where they are needed and in a manner that is as least intrusive as possible. Such an ideal system will be sensitive to the particular circumstances of each market and the regulations applied to each market would adapt to the changing circumstances of each market. This could be called “circumstantial regulation.”

Once upon a time, the circumstances of the telecom industry were fairly uniform and slow to change so statewide and even nationwide regulation embodied in statutes and regulatory codes seemed reasonable.

But today, the circumstances of every geographic telecom market are increasingly unique to that market: the circumstances in Manhattan, Kansas are vastly different from the circumstances in Manhattan, New York and the circumstances of Manhattan, NY are vastly different from those in the small, rural community of Horseheads, NY. And the circumstances of all these markets are different today from a few years ago and they will be different a few years in the future. So, a regulatory policy that is “optimal” for Manhattan, NY today will be sub-optimal for Manhattan, Kansas and Horseheads today and sub-optimal for Manhattan, NY tomorrow. So, to the extent it is necessary at all, statewide and nationwide regulation is increasingly sub-optimal for every market.

Such sub-optimality might have been tolerable (or undetected) during the telecom “boom”, but it is increasingly intolerable in the aftermath of the “meltdown.” However, the current regulatory system inhibits the granular experimentation that could reduce risk in a dynamic industry and can makes regulatory responses to an industry meltdown faster and more effective. The current system’s “gridlock” has spooked investors and prevented the industry and regulators from responding more effectively to the downturn.

Regulatory experimentation should help telecom recovery by minimizing the possibility of “bad” regulatory decisions and speeding the rollout of “good” decisions. Investors would soon understand and
appreciate the certainty, predictability and risk containment inherent in State-federal experimentation and, as a result, be more willing to invest on more favorable terms.

If the Telecom Act has increased investor risk and paralysed management by eliminating experimentation and encouraging decision-making gridlock, what should be done? An obvious answer, of course, is to increase experimentation to reduce gridlock.

The FCC attempted to delegate some decision-making to the States in its third attempt to define what network elements should be unbundled as a result of the “necessary and impair” standard established by the Telecom Act. The Commission’s decision was overturned by the DC Circuit Court as an improper delegation of the authority conferred on the FCC by Congress. However, Congress can (and should) include in any new telecom law a provision that clearly empowers the FCC to delegate its authority to the States and to enlist the States in experiments

**4.6. Reduce Gridlock by Streamlining Remaining Regulatory Processes**

One cause of gridlock is that the regulatory process itself invites it. While some of the gridlock-inducing process is required by fundamental Constitutional requirements of due process and fairness, much of it is self-inflicted by regulators and regulatees. Consequently, many of the streamlining reforms could be implemented by the agencies rather than by legislation. However, to the extent that regulators are unwilling or unable to implement reforms, legislation could require them to do so.

The Advisory Committee experts observed that most State commissions aren’t as gridlocked as the FCC. This observation leads to the obvious thought that the FCC

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**OCT. 2003 CONFERENCE**

Streamline FCC Regulatory Process

- Reduce FCC to one Commissioner
  - Renewable two year term
  - Special safeguards for media content issues
- Imposed meaningful penalties for dilatory use of process
- All appeals to one court (D.C. Circuit)
might be well-served by adopting many of the procedural techniques which seem to reduce gridlock at the State level.

In October 2003, CITI recommended three specific steps to reduce the opportunity for gridlock at the FCC. CITI would update these recommendations to add “Use ALJ’s and contested hearings for fact-finding and adjudicatory decisions” and “encourage States to conduct experiments to lower risk, speed adoption of national policies.”

CITI’s first recommendation in 2003 (“Reduce FCC to one Commissioner”) recognizes that finding solutions to the contentious and difficult issues which are acceptable to at least a majority of five commissioners often means that complex compromises must be fashioned. Compromises, by their very nature, take time to develop, are less clear and are less predictable. They are also more difficult to defend in appellate litigation, meaning that a compromise decision is often less final. A glaring example of this problem is the FCC’s recent Triennial Review unbundling decision which featured five months of public wrangling among the Commissioners between the adoption of an Order at the FCC’s monthly meeting and the release of the text of the Order. The Commission’s voluminous and complex Order was then vacated by an appeals court and unbundling saga still continues.

The chief benefit of a multi-member regulatory commission is the natural “check and balance” of the compromise process. However, checks and balances can be achieved with other mechanisms. CITI’s recommendation of a short, renewable term for a single commissioner is intended to keep the decision-maker on a short leash and provide a reasonable “check and balance” through the reappointment process. Judicial appeals of the single Commissioner’s decisions as well as the normal legislative oversight process also provide additional checks and balances.

There may be some concern that the FCC’s regulation of mass media “content” is not suitable for a single decision-maker and should continue to be regulated by a multi-member commission. This is a legitimate concern which could be addressed, for example, by
splitting the “telecommunications” and “content” responsibilities, perhaps leaving “content” to the existing FCC and transferring “telecommunications” to a new agency headed by a single decision-maker.

Obviously, changing the structure of the FCC requires legislation.

The second CITI 2003 recommendation (“Impose meaningful penalties for dilatory abuse of process”) is intended to discourage obvious abuses of process. Companies with the great financial resources who desire to maintain the status quo can use those resources to support the endless proceedings and litigation which contribute to “gridlock.” Penalties for abusing process need to be sufficiently large in relation to the abuser’s resources that they would deter the abuse. As such, large companies would be subject to larger penalties than smaller companies. Legislation may be required to permit the imposition of substantial penalties.

The third CITI recommendation (“All appeals to one court (D.C. Circuit)”) would streamline the process in two ways. First, it would eliminate the “forum shopping” that frequently accompanies the appeals of FCC decisions as different appellants seek to have appeals heard in different Circuit Courts of Appeals. Second, by designating one appeals court to hear all telecom cases, the Court will develop telecom expertise, resulting (hopefully) in quicker, more consistent and better grounded decisions. Legislation would be needed to implement this recommendation.

A new CITI recommendation for 2004 is that the FCC should use contested hearings before Administrative Law Judges for fact-finding and adjudication instead of the “paper hearing” process. The recommendation is based on the successful process used in most if not all States. State proceedings often utilize a combination of paper filings and on-the-record hearings with cross-examination of witnesses before a hearing officer/administrative law judge or the Commissioners themselves. This can be quicker, more transparent and more sustainable than the current FCC process of relying exclusively on paper proceedings augmented by private lobbying.
Even though the FCC has Administrative Law Judges on its payroll, the FCC hasn’t held a telecom-related hearing in the collective memory of CITI’s Advisory Committee, which goes back to at least the 1970s. Greater utilization of ALJs is within the management purview of the FCC Chairman and would not require legislation (other than appropriations).

5. **Encourage Recovery by Reforming Telecom Taxes (Including Universal Service)**

In addition to regulation, government affects the telecom industry through tax policies. And note that Universal Service fees are included in this discussion as a tax program because that is exactly what they are.

5.1. **Telecom Taxation**

If the industry’s downturn demonstrates one thing it is that telecom companies are no longer the “golden goose” that legislators can use as a privatized tax collector and subsidy distributor.

The first principle is that telecom companies should be taxed no more and no less than any other businesses. This principle could be included in any telecom legislation. The fact is that telecom companies, on average, pay 19 percent of revenues in all sorts of taxes while the typical business pays only 6 percent. In addition to these disproportionate taxes (which can suppress demand), the sheer cost to service suppliers of administering a complex system of federal, governmental, and local taxes is significant.
state and local taxes places a considerable burden on the industry.

The second principle is that, if money beyond normal taxes is extracted from the telecom industry by the government, it should be ploughed back into the industry. Thus, the federal three percent telephone excise tax (which generates approximately $6 billion annually) should be used for programs which relate in some fashion to the telecom industry and not disappear into general revenues.

Government may be able to incent behavior that will encourage telecom recovery. One way is to use government’s purchasing power to buy network resiliency, stimulate broadband or R&D. Alternatively, the government can incent similar behavior through tax credits.

However, tax credits work only when taxes are otherwise payable. Many companies in the telecom sector—perhaps those that need them most—aren’t currently liable for taxes so tax credits are useless and in a sense only favor the companies that are financially strong already. This could be remedied by allowing the tax credit itself to be transferable in a market transaction from a company that has no tax liability to a company with substantial taxes to pay.

### 5.2. UNIVERSAL SERVICE

Universal service is a good idea: reliable, capable telecom service is essential for participation in modern life and every citizen should therefore have reasonable access to essential telecom services. It is an appropriate role for government to guarantee that access.

However, universal service is a social subsidy program, not a telecom regulatory issue, and it should be treated as such. If low income
individuals or all consumers in a very high cost area need to be subsidized, the government should do so.

But leave the telecom industry shouldn’t be involved: government should take direct responsibility for raising and disbursing the telecom subsidies.

And consumers, not companies, should be subsidized. One means for accomplishing this is to provide consumers who need it with additional buying power. This would allow low income individuals and residents of high cost (usually rural) areas to participate in and stimulate a competitive market in the same manner as wealthier or more urban citizens.

Buying power can be increased through a portable voucher that individuals use to buy services at market rates. To keep things as simple as possible and minimize the involvement of the telecom industry and telecom regulators in the subsidy process, telecom vouchers for low-income individuals could be issued automatically to individuals who already participate in the Department of Agriculture’s food stamp program.

To address high cost areas, the “high cost” voucher could be mailed to each home in the market. The size of the “high cost” voucher could be
varied on a zip code or other geographic basis to equal the difference between the largest service provider’s basic retail rate in that market and some affordability level.

Many observers believe that it is not realistic to expect that legislators will have the courage to make Universal Service a social subsidy program funded by direct tax receipts. They suggest that second best solutions are all that can be hoped for: the telecom industry will continue to be enmeshed in the collection and distribution of the subsidies. With that as a given, it is important that the universal service program does not distort the competitive marketplace more than absolutely necessary. That means that all telecom companies must have an equal burden and an equal opportunity to benefit from the subsidy programs.

6. “CONTENT” ISSUES RELATED TO TELECOM RECOVERY

While the scope of CITI’s overall telecom recovery project did not encompass most broadcast, cable TV and similar “media” issues, there are some inevitable overlaps.

Within the Advisory Committee, 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 claim to be 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 telecom companies attempt to “bundle” content in their broadband services or competitive television services. Since broadband is likely to be a significant catalyst for the overall telecom recovery, the inability of broadband telecom operators to obtain content could greatly affect the speed and scale of the broadband-induced telecom recovery.
7. **IF NEW LEGISLATION IS NEEDED, REPEAL THE 1934 ACT AND START FROM SCRATCH WITH A SIMPLE, ADAPTABLE LAW**

There seems to be a growing consensus that the Communications Act of 1934 as amended by the Telecommunications Act of 1996 needs to be revised. The Chairman of the FCC, members of Congress and industry leaders have, to varying degrees, called for substantial changes to the Communications Act.

The main reason for the dissatisfaction is that the 1996 amendments were obsolete when enacted because of the rapid changes in telecom technology and the telecom industry. At best, the 1996 Act was backward-looking, attempting to “fix” problems that became apparent in the decade 1985-95. Whether or not the fixes were successful is debatable. But it is clear that the Act was not forward-looking and therefore did not (and perhaps could not) foresee the rapid evolution of the Internet and broadband communications or the boom-and-bust.

Just as the Congress of 1995-96 was unable to perfectly foresee the future, it is not reasonable to think that Congress will do any better in 2004-05 predicting the future of technology or the industry.

The 1996 Telecom Act was the product of at least 10 years of Congressional inquiry and activity. If the Pandora’s Box of new legislation is opened in 2004-05, it must be closed as quickly as possible to prevent legislative uncertainty from delaying the recovery. This implies that any new legislation must be very simple and very short. And this also argues against attempting to amend the current law since the amending process will encourage every faction to attempt to preserve its special privileges: a sure recipe for legislative gridlock. Finally, to avoid the fast obsolescence that plagued the ’96 act, a new telecom statute should not “micromanage” and it must not embed a static view of the industry into law.

To minimize gridlock and to produce a law with lasting utility, a new telecom law should deal almost exclusively with two subjects:
• **Principles**, that most stakeholders can support so that regulators (and courts) are clear about the statutory goals and objectives; and,

• **Process**, so that final, sustainable decisions can be reached in a short period of time.

Conversely, any new statute should NOT deal with “substance” in the sense of embodying in law Congressional micromanagement of the telecom industry, particularly to resolve current industry disputes or to specify a particular regulatory policy. Any such embodiment is likely to be wrong or obsolete or both.

**PRINCIPLES:**

A new statute should begin with a clear and concise statement of the fundamental goal of the law, perhaps modeled on the similar provisions of the current Communications Act. For example:

“The purpose of this law is to establish and maintain an efficient and reliable nationwide and worldwide telecommunications system capable of providing all persons with access to reasonably priced telecommunications services. The Commission hereby established shall rely, wherever reasonably feasible, on competitive market forces to achieve this purpose and shall regulate telecommunications services and facilities only where and for so long as market forces are insufficient to achieve this purpose or are unable to prevent the abuse of consumers.”

An obsolescence-proof law must also define “telecommunications” and “telecommunications service” very broadly so that it is technology-neutral and can accommodate rapid and unknown technological developments for decades.

A new telecom statute should then empower and require the Commission to follow broadly written principles:
1) Competition is to be preferred in every market to encourage fair prices, innovation and efficiency.

- Network interconnection and the right of consumers to attach any devices to the network and to use telecommunications services without restriction are essential to a competitive market.

2) Where competition is demonstrably insufficient, regulation should be applied on a geographically granular basis to the minimum extent required to achieve the statute’s purpose or to protect consumers from pricing and service abuses.

3) The Federal government has plenary authority over all telecommunications facilities and services.

- The Federal authority shall be delegated broadly to State commissions when the varying circumstances of each locality or region require varying regulatory responses or policies. However, the delegation to the States must include the directives and decisional standards needed to comply with Constitutional requirements and in most cases the Federal Commission would hear initial appeals of decisions made by State regulators pursuant to delegated authority.

4) States may exercise authority, particularly traditional police powers, over telecommunications, telecommunication facilities and telecommunications services provided that such exercise does not conflict with Federal law, policy or regulations. The Federal Commission or courts shall preempt any conflicting State action.

5) The Federal Commission may conduct experiments of limited geographic scope and shall generally encourage States to experiment with regulatory policies by, inter alia, forbearing
from applying Federal laws or regulations that conflict with the experiment.

- A State may petition the Commission for authority to conduct a regulatory experiment of up to two years duration, including any necessary forbearance. Unless the Commission denies the petition within 60 days, the petition shall be deemed granted.

- The best evidence in proceedings before the Federal regulator or other States is the results of relevant State or Federal experiments.

6) Neither Federal nor State regulators shall regulate the price, quality or other characteristics of retail telecommunications services (those predominantly utilized by individual consumers) in the absence of demonstrable consumer abuse.

- States have the initial responsibility for determining the existence of consumer abuse and for determining and applying the least regulation required to eliminate the abuse. The Federal Commission would act if States refused to consider petitions alleging consumer abuse.

- The Federal Commission may issue standards for the States to apply in determining the existence of a consumer abuse and for the regulation of abuses.

- The Federal Commission will hear appeals from State decisions to determine abuse and to regulate or to not regulate as a result.

7) All carrier-to-carrier issues (including but not limited to such matters as collocation, access charges, reciprocal compensation, performance standards, and all other interconnection matters) shall be resolved exclusively by bilateral negotiation and commercial arbitration;
8) The Commission shall allocate and assign all radio frequency spectrum not controlled by the Federal government for government use in the manner it deems most efficient and equitable.

9) Regulators shall be prohibited from requiring telecommunications service providers to be involved in collecting or contributing funds to support “universal service” and regulators shall not require any implicit subsidies in any rate regulation.

- Ideally, another piece of legislation would deal with Universal Service. However, the telecom statute could provide for a non-regulatory mechanism to support Universal Service. One approach would be that individuals eligible for the Department of Agriculture's food stamp program would also receive a telecom stamp from DoA. The dollar amount of the telecom stamp would be the difference between the unregulated retail rate for basic telephone service provided by the largest provider of service in the market (zip code?) and 115% of the national average retail price for such service. The telecom company providing the service selected by the consumer would redeem the stamp from DoA. Telecom stamps should be funded from: a) the 3% telephone excise tax (which shall not be increased); and b) if necessary, general revenues.

10) The Commission may, after due process, revoke blanket licenses for activities that constitute systemic untrustworthiness and may prohibit licensees from employing as managers persons who have a record of untrustworthiness in the telecom business.
**PROCESS**

1) The Commission and State regulators shall forebear from applying any statutory provision for entire geographic markets and all services or on a more granular market-by-market, service-by-service basis as long as such forbearance is likely to better achieve the statutory objectives than regulation.

2) The Commission will consist of a single Commissioner appointed by the President and confirmed by the Senate for two year renewable terms;

3) All adjudicatory proceedings before the federal regulatory agency shall be conducted by Administrative Law Judges except where the Commission determines on a case by case basis that another process would be more efficient, fair and transparent.

4) All appeals of the Commission’s decisions will be made to Court of Appeals for the District of Columbia Circuit.
   - State decisions administering Federal statute are to be appealed to Federal District Court.

5) With respect to service provider negotiation and arbitration:
   - Matters not resolved through bilateral negotiations shall be resolved by a proposed State Commission Order drafted by a commercial arbitrator;
   - Parties may agree to any commercial arbitration procedure but "baseball" arbitration (where the arbitrator many only select the entirety of one of the party’s best and final package of offers regarding all the unresolved issues) will be the default arbitration process;
• Parties can agree that an arbitration result will apply only to specified markets within a State or to any number of specified States but a state-wide scope will be the default.

• The arbitration decision will be submitted to the affected State Commission for ratification; in an appeal, the State must accord the arbitration result “substantial weight” with the opponent of the arbitration decision having the burden of demonstrating that, overall, the arbitration decision is inconsistent with law, Federal policies or is likely to lead to significant harm to public interest;

- Where the arbitration covers more than one State, an ad hoc panel composed of one State Commissioner selected by a majority of the State Commissioners from each affected State will consider the ratification and the majority decision of the ad hoc panel will bind all affected States

- If it does not ratify the arbitrator’s decision, the State Commission’s or ad hoc panel’s only recourse is to order another arbitration.

• "opt-in" would be available for similarly situated carriers that choose to avoid negotiation;
REFERENCES

TO BE COMPLETED PRIOR TO FINAL PUBLICATION