Price Gouging And Competition In The Special Access Market

Our partner, Colleen Boothby, contributed substantially to this article, and we are grateful for her assistance.

Economic regulation serves no good purpose in effectively competitive markets. But it can—and should—play an important role in markets that are not effectively competitive. Indeed, modern regulation was invented in the late 19th century to prevent railroads (and later, power and telephone companies) from price gouging in such markets. Where competition is seen as feasible but has not yet developed, regulation has been employed to stop those with market power from using it to retard or prevent the emergence of competitors. Telecom isn't the only example of this, but it is one of the clearest.

The FCC should not acquiesce in the BOCs' excessive pricing

Special Access Price Gouging

Special access—the dedicated "final mile" circuit that connects business customer sites to carrier switches/nodes—is an essential building block in enterprise networks. It comprises at least 30 percent, and in some cases more than 50 percent, of the cost of connecting business customers to the network and to each other. Bell operating companies (BOC)s must buy it from other BOCs to offer nationwide service, *e.g.*, when AT&T serves customers in Verizon's territory; and BOC competitors rely on it where they do not have their own facilities—which is almost everywhere.

Although there is growing competition among cable companies, wireless companies and traditional telephone companies for residential customers, the special access market below the "OC-*N*" level, and more generally outside major urban areas, lacks effective competition.

BOC earnings on special access offer compelling proof of this. In 2006, AT&T realized a return of about 100 percent on interstate special access service; Qwest earned an astonishing 130 percent; and poor Verizon trailed the pack with a special access return of "only" about 50 percent.

The 2006 returns are not aberrations; they continue the awesome and seemingly ever-increasing special access returns that the BOCs have realized since the FCC granted them "flexibility" for special access pricing—a move that was taken after the passage of the Telecommunications Act of 1996 and justified on the grounds that the BOCs needed the freedom to meet competition. But competition usually produces rate decreases, not rate increases. Companies don't earn these kinds of returns in a mature business when the market is effectively competitive.

The FCC

The Communications Act of 1934 charges the FCC with the responsibility of assuring that rates for interstate telecommunications services are "just and reasonable," the legal way of saying that rates should produce fair returns for carriers and not gouge ratepayers. The BOCs' astronomical special access returns inevitably give rise to the question of how these carriers have gotten away with price gouging in their special access rates?

We believe that there are two principal reasons for the FCC's tolerance of BOC special access pricing. The first is embedded in a commitment to deregulation—a praiseworthy goal, but one that should not (in our view) lead regulators to ignore reality. The FCC granted the BOCs pricing flexibility because the agency and Congress, as a matter of philosophical preference and policy, strongly favored deregulation, even as the deregulatory thrust of the Telecommunications Act of 1996

generated optimism/faith in Washington that competition would emerge in telecommunications markets once the Act was implemented.

As a result, the FCC granted the BOCs pricing flexibility before competition actually arrived. Sure, there were some data suggesting that special access competition *might emerge*, but the agency was really betting that competition *would materialize* in the future. And even though most of the competitive local exchange carriers (CLECs) bit the dust when the tech bubble burst, a Commission philosophically predisposed to deregulation was not inclined to "re-regulate."

The second factor that may have motivated the FCC's tolerance for special access price gouging is rooted in Washington's adoption of broadband availability as an overriding new telecom objective. Even though cable television companies provide broadband service in virtually all the areas they serve, and even though the Universal Service Fund has provided substantial support for the modernization of telephone company plants in rural areas, the BOCs seem to have persuaded the FCC and other DC decision-makers that they can (and will) use the returns produced by excessive special access rates to subsidize the deployment of broadband to residential subscribers.

Excessive special access rates drain billions from GDP and cost hundreds of thousands of jobs

Implicit acquiescence in this cross-subsidization means that the decision maker knows that the special access market is not effectively competitive—i.e., competitive pressures would prevent the BOCs from pricing special access above economic cost so as to produce the excessive earnings supposedly being used to subsidize deployment of broadband-capable plant.

Impact On The Economy

The FCC's implicit acquiescence in the BOCs' special access pricing policies has produced adverse effects on the economy that are significant, though not often considered.

An entity that we represent, the AdHoc Telecommunications Users Committee, has filed a study with the FCC showing that BOC special access price gouging costs special access customers about $20 million per day, an impact that works its way through the economy like any other market failure.

The AdHoc study found that from 2007 through 2009, excessive special access prices are likely to repress the Gross Domestic Product by about $66 billion and cost the economy approximately 234,000 jobs. Turning a blind eye to the problem creates real economic losses.

Threat To Competition

Sprint and other carriers care a great deal about the BOCs' special access price gouging because they all rely on special access circuits to serve customers. Because of the dependence, a BOC can use inflated special access rates in combination with aggressive retail pricing to make it unprofitable for other providers to compete for business which is located predominately in a BOC's home region.

The BOCs are not hurt by each other's high special access prices because although they *pay* them when they operate out of region (*e.g*., when Qwest serves customers in AT&T's home region), they get to *charge* them when other carriers operate in their regions (*e.g*., when AT&T serves a customer in Qwest's region). For the BOCs, special access overcharging is just a matter of moving money from one corporate pocket to another.

This method of competing is known as a "price squeeze." It is possible only because of (a) the absence of effective competition in much of the special access market; and (b) a regulator willing to ignore price gouging because to do otherwise would be to acknowledge the need either to regulate or to sanction overcharging business customers to cross-subsidize deployment of residential broadband service. Whatever the FCC's motivation, competition is adversely affected by this exercise of monopoly power, an ironic result given the pro-competitive goals of the 1996 Telecom Act.

FCC decision making on special access pricing should be driven by market conditions and clearly articulated policies. So far that hasn't been the case. With so much at stake, users should expect more from the FCC□

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