PHOENIX CENTER POLICY BULLETIN NO. 37

PHOENIX CENTER FOR ADVANCED LEGAL & ECONOMIC PUBLIC POLICY STUDIES
www.phoenix-center.org

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November 2014

SECTION 10 FORBEARANCE:
ASKING THE RIGHT QUESTIONS TO GET THE RIGHT ANSWERS

Abstract: The Telecommunications Act of 1996 aimed to "provide for a pro-competitive, *de-regulatory* national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans…." Key to the Federal Communication Commission's ability to satisfy this deregulatory mandate is Section 10 of the Act which provides the agency with express legal authority to forbear from enforcing certain portions of the Communications Act. In this BULLETIN, we use the agency's *Phoenix Forbearance Order* as a template for outlining how the Commission can improve its forbearance analysis. Our analysis focuses on forbearance from the unbundling provisions in the 1996 Act, but we also show how the *Phoenix Forbearance Order* is relevant to the net neutrality debate. In particular, the *Phoenix Forbearance Order* rejects the validity of forbearance in the presence of either monopoly or duopolistic competition. Given the Commission's finding that Broadband Service Providers are "terminating monopolists," forbearance cannot be used to create what is colloquially referred to as "Title II Lite." In fact, if broadband is classified as a Title II service, then the Commission's stance on broadband competition and the *Phoenix Forbearance Order's* conclusions on duopolistic competition likely require, for the first time, the price regulation of all retail broadband connections.

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I. Introduction

According to its preamble, the stated purpose of the Telecommunications Act of 1996 is to "provide for a pro-competitive, *de-regulatory* national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans…."[1] The key statutory tool to facilitate Congress's deregulatory mandate is contained in Section 10 of the 1996 Act[2] which, for the first time, provided the Commission with the express legal authority to forbear from enforcing various portions of the Communications Act once certain conditions are met.[3]

While traditionally a backwater issue, the use of the Commission's forbearance authority has come to the forefront of the debate. For example, with the IP Transition underway, using Section 10 to dismantle what is left of the 1996 Act's unbundling requirements—a paradigm essentially rendered moot by a series of court decisions and, ultimately, the agency's 2004 *Triennial Review Remand Order*[4]—has proven to be a contentious issue at the Commission. In December 2005, the agency forbore from many of the remaining unbundling requirements (including unbundled loops) in parts of the Omaha Metropolitan Statistical Area ("MSA"). The Commission hinged its decision largely on the presence of a facilities-based competitor (i.e., a cable company) which covered much of the Omaha market, determining that this level of facilities-based competition was sufficient to protect end-users as effectively as regulation does in the absence of such competition.[5]

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1 *See* House Report 104-458, 104th Congress (2d Session) (1996) (available at: http://www.gpo.gov/fdsys/pkg/CRPT-104hrpt458/html/CRPT-104hrpt458.htm) (Emphasis supplied).

2 47 U.S.C. § 160.

3 Indeed, the anticipated aggressive use of Section 10 over traditional regulation was one of the prime justifications for the D.C. Circuit's recent finding that the FCC may use Section 706 as a separate source of ancillary authority. *See Verizon v. FCC,* 740 F.3d 623, 638-39 (D.C. Cir. 2014) ("Section 706(a)'s legislative history suggests that Congress may have, somewhat presciently, viewed that provision as an affirmative grant of authority to the Commission whose existence would become necessary if other contemplated grants of statutory authority were for some reason unavailable.")

4 *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, FCC 03-36, 18 FCC Rcd 16978, REPORT AND ORDER AND ORDER ON REMAND AND FURTHER NOTICE OF PROPOSED RULEMAKING (rel. 21 August 2003) (hereinafter *Triennial Review Remand Order*).

5 *In re Petition of Qwest Corporation for Forbearance Pursuant to 47 U.S.C. § 160(c) in the Omaha Metropolitan Statistical Area,* FCC 05-170, 20 FCC Rcd 19415, MEMORANDUM OPINION AND ORDER (rel. December 2, 2005), *aff'd Qwest v. FCC*, 482 F.3d 471 (D.C. Cir. 2007) (hereinafter "*Omaha Forbearance Order*"). The agency did not consider non-cable VoIP providers or competition from mobile wireless. *Id.* at ¶ 72. ("Because Qwest has not submitted sufficient data concerning the full substitutability of interconnected VoIP and wireless services in its service territory in the Omaha MSA, and because the data submitted do not allow us to further refine our wire center analysis, we do not rely here

(Footnote Continued….)

Four years later, the agency would forcibly reject the same request by Qwest for the Phoenix MSA, batterfanging its earlier decision in the *Omaha Forbearance Order*.[6] In the *Phoenix Forbearance Order*, the Commission used an antitrust-type "market power" methodology, which arguably established an impossible threshold for forbearance of unbundled network elements, rendering moot Section 10 as a deregulatory tool.[7] As a result, subsequent to the *Phoenix Forbearance Order*, pending forbearance petitions on unbundling mandates were withdrawn and none have been filed since.[8]

In this BULLETIN, we use the *Phoenix Forbearance Order* as a template for outlining how the agency can improve its forbearance analysis for the unbundling provisions in the 1996 Act so that its approach is more consistent with the economic realities of communications markets and the statute. Our proposals are not a panacea for forbearance policy—there is no one-size-fits-all approach to the varied aspects of forbearance. Nevertheless, improved legal and economic analysis can be used to refocus the Commission's efforts. We also stress that our analysis is not intended to encourage either approval or denial of forbearance petitions—each is unique—but rather to aid in the assessment of the individual cases in a rational, logical manner.

We also consider how the *Phoenix Forbearance Order* impacts the use of Section 10 to write a set of legally-sustainable Open Internet rules. While the Commission has proposed to move forward using its authority under Section 706,[9] there are increasing calls for the Commission to

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on intermodal competition from wireless and interconnected VoIP services to rationalize forbearance from unbundling obligations."). In terms of line counts, unbundling was not far from its peak at the time, though the *Triennial Review Remand Order* had already begun to take its toll (unbundled loop counts fell by one-third between June 2005 and June 2006). *Local Telephone Competition Reports*, Federal Communications Commission (multiple years, Table 4) (available at: http://transition.fcc.gov/wcb/iatd/comp.html).

[6] *In the Matter of Petition of Qwest Corporation for Forbearance Pursuant to 47 U.S.C. § 160(c) in the Phoenix, Arizona Metropolitan Statistical Area,* FCC 10-113, 25 FCC Rcd 8622, MEMORANDUM AND ORDER, (rel. June 22, 2010), *aff'd, Qwest v. FCC,* 689 F.3d 1214 (10th Cir. 2012) (hereinafter "*Phoenix Forbearance Order*"). At the time of the request, the nationwide count of unbundled loops was now less than half the 2005 level and falling fast. *Local Telephone Competition Reports*, *id.*

[7] G.S. Ford and L.J. Spiwak, *The Impossible Dream: Forbearance After the Phoenix Order,* PHOENIX CENTER PERSPECTIVE NO. 10-08 (December 16, 2010) (available at: http://www.phoenix-center.org/perspectives/Perspective10-08Final.pdf).

[8] The impossible-to-satisfy standard has not been lost on those acquiring inputs from the ILECs. There have been requests for the Commission to apply its new "market power" approach to its past deregulatory decisions. *See, e.g., In the Matter of Special Access for Price Cap Local Exchange Carriers; AT&T Corporation Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services,* FCC 12-92, 27 FCC Rcd 10,557, REPORT AND ORDER (rel. August 22, 2012).

[9] *In the Matter of Protecting and Promoting the Open Internet,* FCC 14-61, 29 FCC Rcd 5561, NOTICE OF PROPOSED RULEMAKING (rel. May 15, 2014) (hereinafter "*2014 Open Internet NPRM*").

reclassify broadband Internet access as a common carrier telecommunications service but to use aggressively its authority under Section 10 to create some form of "Title II Lite." As we show below, however, this is a legal impossibility. Given the Commission's finding that Broadband Service Providers are "terminating monopolists," forbearance cannot be used to create what is colloquially referred to as "Title II Lite." In fact, if broadband Internet access is classified as a Title II service, then the Commission's stance on broadband competition combined with the agency's findings in the *Phoenix Forbearance Order* likely require, for the first time, the price regulation of all retail broadband connections.

II. Statutory Background: Section 10

It is a well-established principle of administrative law that an agency may modify or eliminate its regulations.[10] What an administrative agency generally may not do, however, is forbear from relevant portions of its statutory mandate. Such was the case of the FCC which, prior to the passage of the Telecommunications Act of 1996, lacked any authority to forbear from the assorted statutory mandates contained in the Communications Act. As a result, the agency was often forced to engage in legal gymnastics to avoid statutory mandates that had all-too-obviously outlived their usefulness (sometimes failing in these efforts).[11] Recognizing this problem, and consistent with the deregulatory philosophy articulated in the 1996 Act's preamble, Congress included Section 10 in the 1996 Act (entitled "Competition in Provision of Telecommunications Service"), which permits the Commission to forbear not only from its own regulations (which it could always do) but also from select portions of the Communications Act if certain conditions are met.[12] Congress' bias toward deregulation is apparent in the substantial, almost legislative, power embodied in Section 10.

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[10] *See, e.g.*, Communications Act Section 4(i), 47 U.S.C 154(i), which provides that the Commission "may perform any and all acts, make such rules and regulations, and issue such orders, not inconsistent with this chapter, as may be necessary in the execution of its functions."

[11] For example, this inability to forbear was one of the primary motivations behind the Commission's dominant/non-dominant paradigm for long distance services: *i.e.*, dominant firms' tariffs were generally subject to 45 days notice and comment but, lacking the ability to forbear, in order to minimize regulatory burdens on new entrants, the Commission presumed that non-dominant firms' tariffs were just and reasonable after only one day notice. When the FCC tried to eliminate tariff requirements for non-dominant long-distance carriers altogether, the Supreme Court held that the agency lacked this authority. *See MCI v. AT&T,* 512 U.S. 218 (1994).

[12] There are limits to the Commission's authority under this section. Specifically, under Section 10(d), the "Commission may not forbear from applying the requirements of section 251(c) or section 271 under subsection (a) of this section until it determines that those requirements have been fully implemented." Section 251(c) addresses the interconnection and unbundling obligations of Local Exchange Carriers; Section 271 deals with the Local Exchange Carrier entry into the interstate long-distance markets. This limitation is no longer binding as the Commission has determined that Section 271 and 251(c) are already fully implemented for purposes of Section 10(d). *See, e.g., In re*

(Footnote Continued….)

A. *Requirements for Forbearance*

Section 10(a) states that "the Commission shall forbear from applying any regulation or any provision of [the Communications] Act"[13] if the Commission determines that:

(1) enforcement of such regulation or provision is not necessary to ensure that the charges, practices, classifications, or regulations by, for, or in connection with that telecommunications carrier or telecommunications service are just and reasonable and are not unjustly or unreasonably discriminatory;

(2) enforcement of such regulation or provision is not necessary for the protection of consumers; and

(3) forbearance from applying such provision or regulation is consistent with the public interest.[14]

In making its "public interest" determination under Section 10(a)(3), Section 10(b) requires the Commission to:

> … consider whether forbearance from enforcing the provision or regulation will promote competitive market conditions, including the extent to which such forbearance will enhance competition among providers of telecommunications services. If the Commission determines that such forbearance will promote competition among providers of telecommunications services, that

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Petition for Forbearance of the Verizon Telephone Companies Pursuant to 47 U.S.C. § 160(c), FCC 04-254, 21 FCC Rcd 21496, MEMORANDUM OPINION AND ORDER (rel. October 27, 2004), *aff'd*, *Earthlink v. FCC,* 462 F.3d 1 (D.C. Cir. 2006) (hereinafter "*Section 271 Broadband Forbearance Order*"); *Omaha Forbearance Order, supra* n. 5 at ¶ 52-3.

13 Section 332(c)(1)(A) is a forbearance section for mobile wireless carriers that was enacted prior to the passage of the Telecommunications Act of 1996. *See* 47 U.S.C. § 332(c)(1)(a). The terms of 332(c)(1)(A) closely mirror those of Section 10, with Sections 10(a)(1), (2), and (3) exactly coinciding. Section 332(c)(1)(A) precludes the Commission from forbearing from Sections 201, 202, and 208 of the statute, where no such restriction is included in Section 10. For the most part, this difference is immaterial. Section 10(a)(1) mirrors the requirements of Section 201 (just and reasonable rates) and 202 (no unduly discriminatory rates), so forbearance from 201 and 202 is practically precluded by Section 10.

14 47 U.S.C. § 160(a). Commission rules (but not the statute) place the burden of proof, both in the production and burden of persuasion, on the petitioner. *See Petition to Establish Procedural Requirements to Govern Proceedings for Forbearance Under Section 10 of the Communications Act of 1934, as Amended*, WC Docket No. 07-267, REPORT AND ORDER, 24 FCC Rcd 9543 (2009) at ¶ 21 ("the petitioner's evidence and analysis must withstand the evidence and analysis propounded by those opposing the petition for forbearance").

> determination may be the basis for a Commission finding that forbearance is in the public interest.[15]

The interplay between 10(a)(3) and 10(b) could be significant in some instances, though it has not proven to be so thus far.[16] In Section 10(b), Congress expresses a concern that *regulation can be an impediment to competition*, requiring the Commission to consider "whether forbearance … will promote competitive market conditions [and] will enhance competition among providers of telecommunications services." Since competition is the bedrock of forbearance, Section 10(b) is a substantive wrinkle in the agency's forbearance activities.

Finally, Section 10 contains one other relatively unique but important provision: a one-year "shot clock" for Commission action. That is to say, under Section 10(c), if the Commission receives a petition for forbearance, then it must act on such petition within one year otherwise the petition is "deemed granted."[17] This "deemed granted" condition suggests a strong bias to the grant of forbearance, since a grant is provided as the default.

B. *Using Section 10 Forbearance*

Over the years, the Commission has acted on a variety of forbearance petitions. Many of its determinations were relatively uncontroversial, given that the regulations at hand were not of a significant nature (e.g., reporting requirements, accounting rules, and so forth).[18] That said, the Commission has, on occasion, attempted to be somewhat bold in the use of its forbearance

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15 47 U.S.C. § 160(b).

16 For the most part, the Commission's forbearance orders have paid lip service to Section 10(b).

17 47 U.S.C. § 160(c) provides that:

> *"PETITION FOR FORBEARANCE – Any telecommunications carrier, or class of telecommunications carriers, may submit a petition to the Commission requesting that the Commission exercise the authority granted under this section with respect to that carrier or those carriers, or any service offered by that carrier or carriers. Any such petition shall be deemed granted if the Commission does not deny the petition for failure to meet the requirements for forbearance under subsection (a) within one year after the Commission receives it, unless the one-year period is extended by the Commission."*

Section 10(c) permits the Commission to "extend the initial one-year period by an additional 90 days if the Commission finds that an extension is necessary to meet the requirements of subsection (a)."

18 *See, e.g., In re Petition of USTelecom for Forbearance Under 47 U.S.C. § 160(c) from Enforcement of Certain Legacy Telecommunications Regulations,* FCC 13-69, 28 FCC Rcd 7627, MEMORANDUM OPINION AND ORDER AND REPORT AND ORDER AND FURTHER NOTICE OF PROPOSED RULEMAKING AND SECOND FURTHER NOTICE OF PROPOSED RULEMAKING (rel. May 17, 2013) (hereinafter "*USTelecom Forbearance Order*"), *aff'd Verizon and AT&T v. FCC,* __ F.3d __ (D.C. Cir. October 31, 2014).

authority.[19] Nevertheless, given the radical changes in the telecommunications industry since 1996, many parties feel the Commission has squandered the opportunity provided by Section 10. Regulators regulate, and the Commission is a regulator. Unsurprisingly, forbearance can be difficult for the agency, especially when its regulations have created powerful constituencies which benefit from, and are heavily dependent upon, its rules. No doubt, setting aside its unbundling (and other wholesale service) obligations, whether in whole or in part, is consequential, impacting business plans dependent on the regulatory scheme.[20] That said, the conditions for forbearance do not include the protection of specific business plans or particular competitors or types of competitors; forbearance aims to reduce regulations that no longer protect end-users or provide measurable benefits to society.

Given that Section 10 gives the FCC the unique power to refuse to enforce portions of its charter statute, the mere concept of forbearance deserves a bit of contemplation. Plainly, the 1996 Act seeks to promote competition and reduce regulation, substituting the former for the latter. Yet, the Commission has great authority to regulate telecommunications carriers and telecommunications services. If the competitive outcome is the goal, then why not just regulate to the competitive solution? Also, Section 10(a) permits deregulation only if rates, terms and conditions are just and reasonable and not unduly discriminatory, and these are the same standards to which the Commission's own regulations must comply (that is, §201 and §202 of the Act).[21] The statutory expectations of regulation and competition are (for the most part) identical, but Congress still expressed a strong bias in favor of promoting competition and reducing regulation. Its preference for competition is not surprising—not only is regulation is

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19 *See, e.g., In re Policy and Rules Concerning the Interstate, Interexchange Marketplace, Implementation of Section 254(g) of the Communications Act of 1934, as amended,* FCC 96-424, 11 FCC Rcd. 20730, SECOND REPORT AND ORDER (rel. October 31, 1996) at ¶ 22, *aff'd MCI v. FCC,* 209 F.3d 760 (D.C. Cir. 2000) (forbearance from Section 203 tariffing requirements for long-distance carriers)(hereinafter "*IXC Detariffing Order*"); *In the Matters of Petition of the Embarq Local Operating Companies for Forbearance Under 47 U.S.C. § 160(c) from Application of Computer Inquiry and Certain Title II Common-Carriage Requirements,* FCC 07-184, 22 FCC Rcd 19478, MEMORANDUM OPINION AND ORDER (rel. October 24, 2007), *aff'd Ad Hoc Telecommunications Users Committee v. FCC,* 572 F.3d 903 (D.C. Cir. 2009) (forbearing from legacy "dominant carrier" regulation for ILEC IP-based broadband services).

20 *See*, *e.g*., *Phoenix Forbearance Order*, *supra* n. 6 at ¶ 34 ("[after the *Omaha Forbearance Order*] the record indicates that McLeodUSA has removed most of its employees from the Omaha marketplace, has limited its operations primarily to serving its existing customer base, and has ceased sales of residential and nearly all business services in Omaha.").

21 *See, e.g.,* L.J. Spiwak, *The Problems with Henry Waxman's "Hybrid" Legal Theory*, @LAWANDECONOMICS BLOG (October 9, 2014) (available at: http://phoenix-center.org/blog/archives/1941); L.J. Spiwak, *Section 10 Forbearance Offers No Easy Path to "Title II Lite"*, THE HILL (October 21, 2014) (available at: http://thehill.com/blogs/pundits-blog/technology/221342-section-10-forbearance-offers-no-easy-path-to-title-ii-lite).

crude and "far from an exact science",[22] but the agency's deliberative process is often flavored with raw politics.[23] Moreover, most parties would concede that markets, competitive or not, are far too complex for effective central planning, even by an alleged expert agency. The 1996 Act's bias for deregulation seems to reflect these realities, and suggests that in a forbearance proceeding the efficacy of regulation should be given low marks. Put simply—a little bit of competition may be better than a whole lot of regulation. Indeed, by way of analogy, it is interesting to note that in the 1992 Cable Act, Congress explicitly codified the tradeoff between the two, eliminating rate regulation of franchise markets when the market had half a competitor (a trigger Hirschman-Herfindahl Index of 7,450).[24] Thus, in the 1992 Cable Act, Congress expressed *low confidence* in the efficacy of regulation and *high confidence* in the efficacy of competition.

III. Asking the Right Questions

At the most fundamental level, deciding whether to invoke Section 10 forbearance involves a single, simple question: *is society made worse off if a regulation is eliminated?* We use "society" rather than "consumers" because Section 10(a)(1) addresses the concept of "just and reasonable," and both the buyer and the seller are implicated under that rate-setting standard.[25] As for the "worse off" element of the question, society need not be made better off from forbearance, since an ineffective rule serves no purpose, though its presence may serve to reduce competition if there are compliance costs or regulatory risks associated with it (implicating Section 10(b)).

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[22] *See, e.g., Fed. Power Comm'n. v. Conway Corp.*, 426 U.S. 271, 278 (1976*); WorldCom v. FCC*, 238 F.3d 449, 457 (D.C. Cir. 2001); *Sw. Bell Telephone Co. v. FCC,* 168 F.3d 1344, 1352 (D.C. Cir. 1999); *Time Warner Entm't Co. v. FCC,* 56 F.3d 151, 163 (D.C. Cir. 1995); *United States v. FCC,* 707 F.2d 610, 618 (D.C. Cir. 1983); *see also Access Charge Reform*, FIFTH REPORT AND ORDER AND FURTHER NOTICE OF PROPOSED RULEMAKING, 14 FCC Rcd 14221 (1999) at ¶¶ 96, 144 (FCC justified its deregulatory triggers by noting that "regulation is not an exact science"); *see also* G.S. Ford and L.J. Spiwak, *The Need for Better Analysis of High Capacity Services*, 28 JOHN MARSHALL JOURNAL OF COMPUTER AND INFORMATION LAW 343 (2011).

[23] G.S. Ford and L.J. Spiwak, *The Unpredictable FCC: Politicizing Communications Policy and its Threat to Broadband Investment,* PHOENIX CENTER POLICY PERSPECTIVE NO. 14-05 (October 14, 2014) (available at: http://phoenix-center.org/perspectives/Perspective14-05Final.pdf).

[24] The HHI is computed as: $15^2 + 85^2 = 7{,}450$.

[25] It is well established that a "just and reasonable" rate must fall into what is referred to as the "zone of reasonableness"—i.e., it cannot be "confiscatory" on the bottom end (protecting producers) and "excessive" on the high end (protecting consumers). Accordingly, the phrase "just and reasonable" is not "a mere vessel into which meaning must be poured." *See Farmers Union Central Exchange v. FERC,* 734 F.2d 1486, 1504 (D.C. Cir.), *cert denied sub nom.*, 469 U.S. 1034 (1984).

We can formalize a bit by restating the question as whether economic welfare without the regulation, W_U, is greater than or equal to economic welfare with the regulation, W_R, but this formality serves only to draw attention to the fact that welfare functions can be very complicated. Regulation may influence costs, demand, quality, the presence and intensity of competition, and just about any other market factor one can think of. In some cases, regulation just plain stinks; the Commission has conceded that some its own rules and mandates facilitate collusion,[26] are "outdated" and "riddled with inefficiencies," and encourage "wasteful arbitrage".[27] Cable rate regulation mandated by the 1992 Cable Act turned out to be ineffective if not disastrous, curbing investment and reducing quality,[28] and this regulation was largely abandoned four years after it began.[29] As we see it, the complexity in the forbearance analysis does not relate to the question at bar, but rather the search for the answer to that question.

To clarify, consider a simple case where we limit the analysis to price alone, assuming that lower prices are preferred by society if not producers, as long as they are not confiscatory. Let's say, to keep it simple, that the market in question is duopolistically competitive (two firms), with a regulated price, P_R, and a duopoly price P_2. A carrier has petitioned the Commission to forbear from price regulation. Based on the relevant question for forbearance, if $P_2 \leq P_R$, then deregulation is warranted—duopolistic competition is at least as good as regulation. In reality, regulation isn't this simple; regulation is never merely about price, but this fact does not nullify the proper focus of a forbearance proceeding: *is society made worse off if a regulation is eliminated?*

Additionally, in assessing whether society is worse off if a regulation is eliminated, it is critical that the agency assess the efficacy of the regulation in question. In some cases, decades-old regulations are non-binding and thus ineffective at producing any consumer benefit. In others, regulation may be actively harmful to consumers, raising or shifting costs. Regulation is not a free lunch; it may be very costly. In some cases, the benefits of regulation may be small, especially as firms adjust their activities to evade regulation or the regulated service becomes

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[26] *See IXC Detarrifing Order supra* n. 19.

[27] *See, e.g., In the Matter of Connect America Fund, A National Broadband Plan for Our Future, Establishing Just and Reasonable Rates for Local Exchange Carriers, High-Cost Universal Service Support, Developing an Unified Intercarrier Compensation Regime, Federal-State Joint Board on Universal Service, Lifeline and Link-Up, Universal Service Reform – Mobility Fund,* 26 FCC Rcd 17,663, FCC 11-161, REPORT AND ORDER AND FURTHER NOTICE OF PROPOSED RULEMAKING (rel. November 18, 2011) at ¶9 (FCC describing its regulations as "outdated", "riddled with inefficiencies," and creating "opportunities for wasteful arbitrage"), *aff'd, In re FCC 11-161,* 753 F.3d 1015 (10th Cir. 2014).

[28] T. Hazlett and M. Spitzer, PUBLIC POLICY TOWARD CABLE TELEVISION: THE ECONOMICS OF RATE CONTROLS (1997).

[29] The 1996 Telecommunications Act eliminated FCC's ability to regulate the rates for non-basic service tiers for small systems as of 1996 and for all systems as of 1999. *See* 47 U.S.C. § 543(c)(4).

obsolete. In fact, if costs are high and benefits low, forbearance may be beneficial to consumers even under monopoly supply. Moreover, in some cases market power will be entirely irrelevant to the efficacy of price regulation.[30] Plainly, a "market power" standard is too narrow to serve as a general framework, and in some cases entirely irrelevant to the question of forbearance.

Deciding whether or not society is worse off if a regulation is eliminated also involves a temporal component. Removing regulations essential to particular business plans, like unbundling, may very well hurt some providers in the short run. Forbearing from price regulation may lead to higher prices for some customers, or an increase in discriminatory pricing. If the Commission took a very short-run view of the effects of eliminating regulation, then it may be able to conjure up some horror stories. In the longer-run, however, the costs of deregulation will diminish as both competition increases and consumers adjust to market realities. In assessing the consequences of any forbearance action, therefore, both petitioners and the Commission should explicitly state the time period being used in assessing the consequences of forbearance.

IV. Forbearance and Unbundling

Without question, forbearance from the unbundling obligations of the 1996 Act poses a great challenge to the Commission. Much has been invested in the regulatory scheme by the agency, state regulators, and telecommunications companies. Nevertheless, the Commission has over the years chiseled away at the unbundling regime, dealing a significant blow in its 1999 *UNE-Remand Order* and then knocking it to the floor with its 2004 *Triennial Review Remand Order*.[31] The evidence bears this out. In 2004, there were 19.6 million unbundled loops in operation; today, that number stands at a paltry 6.3 million (and still falling) or about 5% of end-user access lines (see Table 1 below). Almost all of these unbundled loops are used to serve business rather than residential customers (a distinction that is likely relevant for market definition and analysis purposes).

In 2005, the agency issued its first decision forbearing from portions of its unbundling rules. The *Omaha Forbearance Order* found that facilities-based competition in the Omaha MSA was sufficient to protect consumers even in the absence of the unbundling mandates.[32] The agency's

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30 *See* T.R. Beard, G.S. Ford and L.J. Spiwak, *Market Definition and the Economic Effects of Special Access Price Regulation*, 22 COMMLAW CONSPECTUS 237 (2014).

31 For a detailed examination of the rise and ultimate demise of the U.S. unbundling paradigm, *see* G.S. Ford and L.J. Spiwak, *Lessons Learned from the U.S. Unbundling Experience*, PHOENIX CENTER POLICY PAPER NO. 45 (June 2013) (available at: http://www.phoenix-center.org/pcpp/PCPP45Final.pdf).

32 *Omaha Forbearance Order*, *supra* n. 5.

internal conflict on unbundling came to a head in the *Phoenix Forbearance Order* in which it rejected Qwest's petition for forbearance on unbundling. The *Phoenix Forbearance Order* was a landmark decision that not only viciously criticized the *Omaha Forbearance Order* but also proposed to establish a "market power" based framework for assessing forbearance petitions involving the elimination of regulations that coerce carrier-to-carrier (i.e., wholesale) transactions.[33] Since the unbundling regime represents the bulk of the 1996 Act's regulatory addendum to the Commission's mission—a regulatory expansion that is at odds with the Act's deregulatory bias—we focus our attention on the *Phoenix Forbearance Order.* Given that the Commission's *Phoenix Forbearance Order* was highly critical of and in opposition to the arguments used in the *Omaha Forbearance Order* to forbear from certain unbundling requirements, we briefly review the earlier order to provide context.

A. *Omaha Forbearance Order*

In 2004, Qwest filed a forbearance petition requesting relief from a number of regulatory requirements, including price-cap regulation and some unbundling obligations, in its service territories located in the Omaha MSA. The Commission granted forbearance for many regulations in its 2005 *Omaha Forbearance Order*, but did not grant all Qwest requested. In the *Order*, the agency followed its general approach to market analysis—it defined markets, computed market shares, and so forth, and concluded that "the level of facilities-based competition ensures that market forces will protect the interests of consumers and regulation is, therefore, unnecessary."[34] The "facilities-based competition" relied primarily upon in the *Omaha Forbearance Order* was the presence of a cable operator (Cox Communications) successfully offering and acquiring significant market share for telephone services in portions of the Omaha market.[35] Where the cable operator was found to have a limited presence, forbearance was not granted.[36] In light of the Act's deregulatory bias, the agency noted that it was "ready and willing to step aside as regulators and let market forces prevail where facilities-based competition is robust."[37]

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33 *USTelecom Forbearance Order*, *supra* n. 18 at ¶ 26 (Pointing to the *Phoenix Forbearance Order*, the Commission stated: "The Commission has required carriers seeking forbearance from wholesale obligations in other contexts, such as loop unbundling, to demonstrate that there is sufficient competition to ensure that, if we provide the requested relief, the carriers will be unable to raise prices, discriminate unreasonably, or harm consumers.").

34 *Omaha Forbearance Order, supra* n. 5 at ¶ 1.

35 *Id.* at ¶ 61.

36 *Id*.

37 *Id.* at ¶ 1.

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The agency's decision was based on "examining the status of competition in the retail market as well as the role of the wholesale market in the Omaha MSA."[38] For the retail market, the Commission was satisfied that "Cox has extensive facilities in the Omaha MSA capable of delivering both mass market and enterprise telecommunications services." The Commission ignored the role unbundled elements played in the competitive landscape, noting "that competition based on UNE loops and transport make up a minor portion of the competition in the Omaha MSA."[39] Thus, the Commission determined that it was the facilities-based competition alone in the retail market that warranted forbearance, though it recognized that a number of unbundling rules would remain in place that would permit some continuance of service provision by users of unbundled elements.

In regards to the public interest condition in Sections 10(a)(3) and 10(b), the agency offered a number of reasons why forbearance was consistent with the public interest. First, the agency concluded that the facilities-based competition satisfying Section 10(a)(1) and 10(a)(2) implied forbearance was in the public interest.[40] Second, the agency concluded that "granting Qwest relief from its loop and transport unbundling obligations in parts of the Omaha MSA will help promote competitive market conditions and enhance competition among providers of telecommunications services as contemplated by Section 10(b)."[41] Third, the agency compared the costs and benefits of the unbundling regulations, concluding, "… the costs of unbundling obligations in parts of the Omaha MSA outweigh the benefits [],” providing an accurate account of the purpose of the unbundling regime as "a high degree of regulatory intervention [that] may initially be required in order to generate competition among direct competitors in a situation where one carrier owns the telecommunications network that will be used to provide service to a single pool of customers."[42] The agency concluded that "[w]hile the costs of such regulatory intervention may be warranted in order to foster competitive entry into the local exchange and exchange access markets where such competition would not otherwise be generated, we find that these costs are unwarranted and do not serve the public interest once local exchange and exchange access markets are sufficiently competitive, as is the case in certain limited areas of the Omaha MSA."[43] Finally, the Commission determined that "we conclude that our decision today will further the public interest by increasing regulatory parity in the telecommunications

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38 *Id.* at ¶ 65.

39 *Id.* at ¶ 68.

40 *Id.* at ¶ 75.

41 *Id.* at ¶ 75.

42 *Id.* at ¶ 76.

43 *Id.* at ¶¶ 76-7.

services market in the Omaha MSA."[44] Today, given the substantial line loss of the ILEC, both to mobile wireless and landline competitors, regulatory parity should be an important consideration for the Commission.

B. *The Phoenix Forbearance Order*

Following its success in the Omaha market in 2005, Qwest returned to the Commission two years later with a petition for forbearance in the Phoenix MSA. It did not go well. In the *Phoenix Forbearance Order*, the Commission decided that "[w]ith the benefit of hindsight and upon further consideration, we conclude that there is a better analytical framework than the one the Commission employed in the *Qwest Omaha Forbearance Order*."[45] The agency did not stop at offering a "better analytical framework," but would batterfang its *Omaha Forbearance Order*, stating (among other things): (a) "there does not appear to be a basis for relying on the predictive judgments the Commission made there"; (b) "problematic elements of the framework used in the *Qwest Omaha Forbearance Order*"; (c) "the order does not adequately explain why it is appropriate to use fundamentally different analytical methodologies to evaluate competition for purposes of unbundling relief versus relief from dominant carrier regulation"; (d) "[t]his higher-level analysis led to certain conclusions that were not adequately justified as a matter of economics." Certainly, the Commission can change its mind and has done so many times, but such a barbed attack on its own precedent is rare, if not unique.

In the *Phoenix Forbearance Order* the Commission announced that it was going to adopt a new "market power" analysis for its Phoenix MSA forbearance review (and those subsequent to it). As the Commission noted, "we find it appropriate to return to a competitive analysis that more carefully defines the relevant product and geographic markets and examines whether there are any carriers in those markets that, individually or jointly, possess significant market power."[46] While the *Phoenix Forbearance Order*'s market definition analysis was not materially different than was its predecessor's, the market power standard was a significant change. Under the agency's new standard, forbearance is not based on the relative efficacy of regulation and competition, but rather requires "the petitioner [to] demonstrate that it lacks market power," not only in the retail market but for wholesale services as well.[47] In other words, regulation is seen as the "default" position, and forbearance must be "earned" by a strict demonstration emphasizing structural industry characteristics. Market power is defined in the

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44 *Id.* at ¶ 78.

45 *Phoenix Forbearance Order, supra* n. 6 at ¶ 24.

46 *Id.* at ¶ 21.

47 *Id.* at ¶¶ 2, 94.

Phoenix Forbearance Order as "the power to control price … resulting in prices *above competitive levels*."[48] We turn next to a discussion on the evaluation of forbearance petitions, using the *Phoenix Forbearance Order* as the background for discussing whether or not a "market power" standard applied to a "wholesale market" is appropriate for evaluating Section 10 forbearance.

V. Why the Commission Must Abandon the *Phoenix Forbearance Order*

In the previous Sections, we outlined both the relevant statutory texts and what we believe to be the important policy questions that need to be asked when reviewing a petition for forbearance. In this section, we briefly outline how the Commission failed to undertake these basic tasks when promulgating its new "market power" standard in the *Phoenix Forbearance Order.*

A. *The "Market Power"/"Competitive Levels" Standard Asks the Wrong Question*

In the *Phoenix Forbearance Order*, the Commission requires "the petitioner [to] demonstrate that it lacks market power,"[49] where market power is defined as "the power to control price … resulting in prices *above competitive levels*."[50] There are two profound defects in this approach. First, the Commission's market-power approach does not ask the right question. Second, the definition of "competitive levels" is inappropriate. Let's tackle the latter first.

A critical issue in this market-power approach to forbearance is what the agency considers to be the "competitive level" of price.[51] Ignoring the most basic principles of telecommunications economics, the Commission defines the "competitive level" of pricing as the pricing outcome of Bertrand Competition "under the assumption of perfectly homogeneous products and no capacity constraints even in the short run."[52] Bertrand Competition under these assumptions has firms cutting price until the price just equals short-run marginal cost (of

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48 *Id.* at ¶¶ 5, 28, 30, 82.

49 *Id.* at ¶¶ 38, 94 (emphasis supplied).

50 *Id.* at ¶¶ 5, 28, 30, 82.

51 *Id.* at ¶ 24. The point is made again at ¶ 43 ("The forbearance criteria could not be met, however, if Qwest … could profitably sustain supracompetitive prices").

52 *Id.* at ¶ 86 and n. 91. Bertrand Competition means firms compete by cutting price; Cournot Competition, in contrast, has firms competing by changing quantities. With homogeneous goods, the outcomes of the two strategies are very different. Bertrand with a capacity constraint renders the Cournot outcomes. *See* D. Kreps & J. Scheinkman, *Quantity Precommitment and Bertrand Competition Yield Cournot Outcome,* 14 BELL JOURNAL OF ECONOMICS 326-337 (1983).

the second lowest cost firm in fact).[53] Bertrand Competition, therefore, renders the perfectly competitive outcome with only two firms, a result so odd that it is sometimes termed the "Bertrand Paradox,"[54] because with fixed costs, such intense competitive response leads paradoxically to monopoly (or sustains a monopoly by discouraging entry, even of an equally efficient rival). Nevertheless, Qwest's Phoenix petition was denied because the agency "[had] no evidence in the record … suggesting that these conditions are present in the markets at issue."[55] Of course, evidence of short-run marginal cost pricing will likely never be present in telecommunications markets, making forbearance under the Commission's new "market power" approach impossible. The production of telecommunications services requires large (and often sunk) capital expenditures, and these fixed costs render declining average costs (i.e., scale economies), or what is often called "increasing returns," a situation recognized by the Commission.[56] Under such conditions, theory calls for regulation to set price equal to average cost, not short-run marginal cost. This fact is well established in literature of telecommunications regulation, all of which the agency ignored in the *Phoenix Forbearance Order*.[57]

Now, let's return to the relevant question. In the *Phoenix Forbearance Order*, the agency requires "the petitioner [to] demonstrate that it lacks market power" to grant forbearance. *But, the relevant question is not whether there's market power, but whether or not society is no worse off if the regulation is eliminated.* Plainly, the *Phoenix Forbearance Order* asks the wrong question. The defect in the Commission's approach can be demonstrated by going back to the simple model of

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53 D. Carlton and J. Perloff, MODERN INDUSTRIAL ORGANIZATION (2005) at p. 173 ("The only possible Bertrand equilibrium … is $p = MC$"). The focus of the analysis is obviously on short-run pricing. The long run in economics is a fiction. Any observed, real-world outcome, such as the present state of competition and regulation, is a short-run phenomenon. It is the actual state of competition, and possibly the actual threat of competition, that is relevant for forbearance analysis.

54 *See, e.g.*, J. Tirole, THE THEORY OF INDUSTRIAL ORGANIZATION (1988) at p. 211.

55 *Phoenix Forbearance Order*, *supra* n. 6 at ¶ 86.

56 *Id*. at ¶ 11 ("the Commission focused on those operational and economic barriers to entry that are linked to natural monopoly characteristics, in particular: "(1) economies of scale (2) sunk costs"); *id.* at n. 143 ("The record evidence indicates that Qwest's competitors, absent leasing facilities from Qwest, would be unable to provide a timely supply response and that this response would likely require investment in significant sunk costs"). In many other documents the FCC explicitly acknowledges the supply-side conditions of the telecommunications market. *See, e.g.*, CONNECTING AMERICA: THE NATIONAL BROADBAND PLAN, Federal Communications Commission (March 16, 2010) (available at: http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-296935A1.pdf) (hereinafter the *National Broadband Plan*) at pp. 36-7; *In the Matter of Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers,* FCC 03-36, 18 FCC Rcd 16,978, REPORT AND ORDER AND ORDER ON REMAND AND FURTHER NOTICE OF PROPOSED RULEMAKING, (rel. August 21, 2003) at ¶¶ 84-88 (hereinafter "*Triennial Review Remand Order*").

57 The issue is detailed in *The Impossible Dream*, *supra* n. 7.

forbearing from price regulation above. Let's permit the "competitive level" of price to be that associated with a very large number of sellers (where price will be close to marginal cost), say ten competitors, labeled P_{10}. According to the *Phoenix Forbearance Order*, forbearance is not permitted unless $P_2 \leq P_{10}$.[58] Unless the regulated price is equal to P_{10}, this inequality is plainly an inappropriate and irrelevant comparison but is nonetheless exactly the one proposed in the *Phoenix Forbearance Order*.[59] By looking to a "competitive level," the Commission has failed to focus on the regulation, which is the true target for comparison. Only if the agency's regulations have produced a price equal to the "competitive levels"—which is implausible[60]—will the *Phoenix Forbearance Order*'s market power approach make sense.

Similarly, the *Phoenix Forbearance Order*'s focus on potential collusion makes the same error. In rejecting the forbearance request, the Commission, in its *Phoenix Forbearance Order*, states: "when there are only a few firms in a market, they are more likely to engage in coordinated interaction includ[ing] tacit as well as explicit collusion, and can result in supracompetitive pricing."[61] In fact, theory does not say firms "are likely" to recognize their mutual interdependence, it assumes they do. ("Are likely" is an empirical statement, not a theoretical one.) Nevertheless, the potential for collusion cannot be dismissed, but even in the presence of collusion, the elimination of regulation may be warranted. Going back to the simple price comparison above, say that a symmetric duopoly is engaged in some form of collusion rendering a price that is equivalent to a market with 1.5 firms, or $P_{1.5}$.[62] Granting forbearance in such a situation is prescribed when $P_{1.5} \leq P_R$. (In light of the general poor quality of regulation, it is not difficult to imagine this condition being satisfied.) By juxtaposing $P_{1.5}$ and P_2, the Commission has again asked the wrong question. In deciding a forbearance petition, the agency must consider how well regulation works—not theoretically, but practically— and how much competition is sufficient to accomplish the same outcomes. In most cases, competition, even in small numbers, produces non-cooperative outcomes with price approximating average cost.

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58 As discussed below, and in *Impossible Dream*, *id.*, this case is pretty much exactly what the *Phoenix Forbearance Order* proposes, that is, simple Bertrand Competition with homogenous goods.

59 If the agency can set a price equal to such a high level of competition, it is sensible to ask why we need competition.

60 In essentially every case, competitive entry into telecommunications services has reduced prices and increased quality, which is why competition is so desirable.

61 *Phoenix Forbearance Order, supra* n. 6 at ¶ 30; *see also Qwest v. FCC, supra* n. 6, 689 F3d at 1233-34 (given the "well-documented anticompetitive risks of duopoly", coupled with the decline of UNE competition, the agency's new "market power" test was not unreasonable).

62 We recognize that such an outcome is infeasible in a homogenous Bertrand situation, as is any outcome but the monopoly one.

B. *A Focus on Retail Markets*

In both the *Omaha* and *Phoenix* proceedings, Qwest sought forbearance from certain unbundling obligations, appealing primarily to the presence of a facilities-based competitor (a cable company) as sufficient to protect consumers in the absence of the competition provided by those offering retail services using unbundled elements acquired from Qwest under regulatory mandates.[63] In the *Omaha Forbearance Order*, the Commission agreed—facilities-based competition was deemed sufficient to protect competitors even if forbearance eliminated the competition from unbundled elements.[64] In contrast, in the *Phoenix Forbearance Order* the Commission defined and evaluated a separate "wholesale market" for unbundled elements, and found that "the record reveals that no carrier besides Qwest provides meaningful wholesale services throughout the Phoenix marketplace…."[65] While the *Omaha Forbearance Order* found the same,[66] only the *Phoenix Forbearance Order* rejected forbearance on such grounds.

These two findings conflict, so it natural to consider which decision is more consistent with the statute. By its plain language, Section 10(a) permits forbearance if and only if rates remain just and reasonable and consumers remain "protected" in the absence of regulation.[67] The statute appears focused on retail markets. As such, a strong case can be made that the *Omaha Forbearance Order* takes the correct approach, focusing on whether there is sufficient competition (from whatever source) in the retail market to protect consumers. While the unbundling rules mandate the local exchange company to sell portions of its network, such transactions do not constitute a "market" in any meaningful sense. As observed by the Supreme Court in *Verizon v. Trinko*:

> The unbundled elements offered pursuant to §251(c)(3) exist only deep within the bowels of Verizon; they are brought out on compulsion of the 1996 Act and offered not to consumers but to rivals, and at considerable expense and effort.[68]

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63 Competition provided by mobile wireless industry and over-the-top VoIP providers was part of the petition.

64 In the *Omaha Forbearance Order*, the agency did not ignore the wholesale exchange of services, but it did not elevate the regulatory-mandated unbundling obligations to "market" status.

65 *Phoenix Forbearance Order*, *supra* n. 6 at ¶ 2.

66 *Omaha Forbearance Order*, *supra* n. 5, at ¶ 67.

67 *C.f., Verizon and AT&T, supra* n. 18, slip op. at 16 (upholding FCC's denial of forbearance because "FCC reasonably concluded that it continued to need Part 32 data to ensure that access rates were not discriminatory….")

68 *Verizon v. Trinko,* 540 U.S. 398, 410 (2004).

As made clear by the court, there is no "market" for unbundled elements—network elements are "sold" to rivals under duress and at great expense. The unbundling mandates created this "wholesale market" out of thin air; this "wholesale market" did not and perhaps does not exist outside the minds of Congress and the Commission.[69] To determine a forbearance request by the presence or absence of competition in a fabricated market is improper.

Given the high-cost of supply and the intensely-regulated nature of this alleged "wholesale market," there is also a strong dose of circularity to the agency's logic. The prices and terms of this alleged "wholesale market," established by regulators and not market forces, could be so unattractive that there is no reason for other firms to enter the "wholesale market." A lack of entry into the "wholesale market" merely implies that no carrier believes there's any money in selling unbundled elements, and the Commission's rules are relevant to the potential entrant's entry decisions. In essence, the Commission has created a market that is regulated on such terms that no firm wishes to enter it, then, after doing so, the agency uses this lack of entry to reject a forbearance request.

Again, it helps to return to the central question: is society made worse off if a regulation is eliminated? *Unbundling is the regulation*—it is not the economic transaction of interest. It is not an economic transaction at all—it is coerced. The relevant question for forbearance is if unbundling is eliminated, then are rates faced by consumers expected to be unjust or unreasonable? Are consumers left unprotected? Even in the face of facilities-based competition, the answer may be "yes," but this finding is not based on whether there is competitive supply of a highly-regulated, forced transaction—the conclusion is supported by an appeal to the retail market. The Commission may very well determine that competition from unbundled elements adds meaningfully to retail market competition, though with facilities-based competition the case would be difficult to make. That said, the relevance of these transactions is on the retail market, not the "wholesale market." Also, the presence of competition in the supply of network elements may be relevant, but only because of its effect on the retail market. Competition in telecommunications can work to benefit consumers whether there is a wholesale market or not.

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[69] In the long distance market, capacity was sold on a wholesale basis, so we cannot exclude the possibility that there could be a wholesale market for capacity. For most carriers, doing so was voluntarily, however, and not mandated by rules. That said, there need not be such a market. *See* T.R. Beard, G.S. Ford and L.J. Spiwak, *Why ADCo? Why Now? An Economic Exploration into the Future Industry Structure for the "Last Mile" in Local Telecommunications Markets*, 54 FEDERAL COMMUNICATIONS LAW JOURNAL 421 (May 2002), predicting the emergence of a wholesale (only, possibly) carrier based on customer acquisition costs. The cable company, however, has customers, so the market has not evolved in the way predicted by that paper.

C. *Costs, Benefits and the Shrinking Market for POTS*

In 1996, the incumbent LECs were capable of serving essentially every home in the country, and provided service to about 95% of them.[70] There was no broadband Internet service to speak of, and basic telephone service was a stable, viable product. Things have changed. About 40% of households have abandoned the wireline telephone market altogether, and cable operators and other VoIP providers provide wireline voice service to about one-third of customers.[71] Today, the incumbent LECs provide service to less than half of households.[72] The wireline voice market is shrinking, not only for the incumbent LECs, but for all wireline carriers. Since 2009, incumbent LEC lines have fallen from about 180 million to about 107 million in 2013.[73] Over the same interval, all access lines have fallen from about 190 million to 150 million. The number of access lines served using unbundled elements has also fallen spectacularly over the past 10 years to the point of being inconsequential. Peaking at nearly 20,000 access lines served using unbundled elements in 2004, that number fell to about 6 million lines access lines as of June 2013. (In the final column of Table 1, we see that the ILECs report only providing only 2.8 million unbundled loops in June 2013, an amount far below CLEC-reported access lines. This difference is perhaps explained, in part, by the provision of multiple lines over a single facility). Only 5% of access lines are served using unbundled elements. Moreover, unbundled elements are rarely used today to provide residential service, suggesting any analysis of forbearance should separate the residential and business customers into distinct markets.[74] Commission

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70 *Telephone Subscribership Report*, Federal Communications Commission (2011) at Table 1 (93.9% of homes had a subscription to telephone service in November 1996) (available at: https://apps.fcc.gov/edocs_public/attachmatch/DOC-311523A1.pdf).

71 *Wireless Substitution: Early Release of Estimates From the National Health Interview Survey, January–June 2013*, Center for Disease Control (December 2013) at p. 1 (available at: http://www.cdc.gov/nchs/data/nhis/earlyrelease/wireless201312.pdf) ("Two in every five American homes (39.4%) had only wireless telephones (also known as cellular telephones, cell phones, or mobile phones) during the first half of 2013—an increase of 1.2 percentage points since the second half of 2012. In addition, nearly one of every six American homes (15.7%) received all or almost all calls on wireless telephones despite also having a landline telephone.")

72 In June 2013, Commission data indicates that incumbent LECs had a 58% market share of wireline access lines. With only 60% of households having a wireline phone (*id.*,), this would put the share of lines provided by the incumbent LECs below 50%. LOCAL TELEPHONE COMPETITION: STATUS AS OF DECEMBER 31, 2013, Industry Analysis and Technology Division, Wireline Competition Bureau (October 2014) (available at: http://transition.fcc.gov/Daily_Releases/Daily_Business/2014/db1016/DOC-329975A1.pdf) (hereinafter "*Local Competition Report*") at Tables 9-11.

73 *Local Competition Report* (2013), *id.* at Table 1.

74 *Firms are Not Passive Recipients of Regulation*, COMMUNICATIONS DAILY: WIRELINE (June 27, 2013) (Quoting CLEC attorney Thomas Jones: from the perspective of the mass residential market, unbundling is "not really

(Footnote Continued….)

data indicates that only 14% of CLEC access lines serve residential customers (using all provision modalities and not just unbundled elements), constituting a market share of total access lines of less than 4% in the residential sector.[75] (We suspect a strong case could be made today for forbearing from all the unbundling requirements nationwide for the residential market.)

Table 1. Shares of End-User Switched Access Lines

	End-User Switched Access Lines				Shares			
Year	UNE	VoIP	Other Non-ILEC	ILEC	UNE	VoIP	ILEC	ILEC-Reported UNE Loops
2004	19,624	…	…	147,993	…	…	…	23,057
2005	19,025	…	…	143,758	…	…	…	20,691
2006	12,547	…	…	142,293	…	…	…	14,579
2007	11,511	…	…	134,640	…	…	…	12,032
2008	10,884	…	…	124,606	…	…	…	10,241
2009	8,631	23,032	12,688	112,748	5%	15%	72%	9,131
2010	7,701	26,895	14,481	102,395	5%	18%	68%	8,403
2011	6,950	30,136	15,734	93,394	5%	21%	64%	7,662
2012	6,654	33,948	15,142	85,848	5%	24%	61%	7,185
2013	6,320	37,257	13,013	78,537	5%	28%	58%	2,788

Source: FCC Local Competition Reports (2009, 2011, 2014), Tables 1, 3, 4, 5.

In contrast to competition from unbundled elements, cable company and other IP-based carrier provision of telephone service has been a resounding success, growing to a level that outpaced unbundling even in the latter's heyday. In June 2003, FCC data indicates that 28% of end-user switched access lines are serviced by non-ILEC VoIP providers (including cable operators). Table 1 shows that the first year VoIP line data was reported, the VoIP providers had acquired more lines (23 million) than CLECs ever had using unbundled elements (peaking at just under 20 million lines in 2004).

In both the *Omaha Forbearance Order* and the *Phoenix Forbearance Order* the Commission did not consider mobile wireless service as a competitor to wireline telephone service. But mobile wireless substitution has done much to shrink the market for wireline service. Even if the agency treats the mobile wireless and wireline services as independent, the cord-cutting data does have relevance in a forbearance case, especially in relation to maintaining a regime of unbundled network elements. The cost of maintaining an unbundling operation at an ILEC is

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available anymore … [but it is] very, very important in the business market."); *see also Local Competition Report* (2013), *id.* at Tables 3 and 4.

[75] *Local Competition Report* (2013), *id.* at Tables 9-11.

likely not small, as the carriers must have ordering and billing systems, dedicated personnel, and so forth.[76] As a consequence of mobile substitution, these costs are spread across a dwindling number of incumbent LEC customers (whether directly or using unbundled loops). Given scale economies, the average cost of the unbundling regime is likely to be large, and an updated cost models reflecting line-loss would imply that the cost of the element itself has risen significantly, attenuating the already marginal effect (if any) of unbundling on the retail market.[77] The competitive effect of unbundling is further attenuated by the fact the price of unbundled elements alone is very close to, in many cases, the retail price for telephone service offered by the typical cable operator, leaving little to no margin for the CLEC.[78] So, while many parties attribute the decline in unbundled element competition to the Commission's 2004 *Triennial Review Remand Order*, which admittedly was a significant blow to the unbundling regime, the fact is that CLECs would not have fared well against VoIP competitors at the regulated prices for unbundled elements in any case, especially in the residential market. As wireless substitution and widespread facilities-based competition rise, the potential benefits of unbundling are dwindling yet the costs of the regime are likely rising (especially on an average cost per unbundled line basis), strengthening the case for forbearance.

Perhaps the unbundling issue can be boiled down to a very basic inquiry: Would there have been a 1996 Act requiring the local phone company to unbundle its network at regulated rates if at the time 40% of households did not have a wireline phone, facilities-based competitors served nearly a third of the wireline business using digital technologies, Internet services had mostly replaced voice communications, and the phone company provided service to less than half of households? We doubt it, yet the Commission refuses to forbear from the unbundling requirements.

VI. Realistic Expectations of Market Structure

Regulation aims to approximate efficient outcomes, which roughly means to imitate competitive outcomes. It does the job poorly in most cases, but imitation is nevertheless its purpose. As such, it is critical to have realistic expectations about the potential for competition

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[76] *Omaha Forbearance Order*, *supra* n. 5 at ¶ 76 ("we conclude that the costs of unbundling obligations in parts of the Omaha MSA outweigh the benefits"); *see also Verizon and AT&T, supra* n. 18 ("It may well be that petitioners' contention that Part 32 data is no longer justified by the expense will prove more compelling.").

[77] The cost models assume the incumbent LEC offers service to the entire market and provides all services to it. TELRIC is an average-cost methodology, so the implied loop rates will rise as the market share of the modeled carrier falls.

[78] For example, the unbundled loop rate in Arizona, for example, was set at $22.65 per month (http://www.researchedge.com/MBTAS/ATIC_MBTAS.pdf). Cox Cable offers a telephone service for about $23.99 (http://www.cox.com/residential/phone.cox).

and the efficacy of regulation. By failing to establish reasonable expectations of competition in telecommunications markets, the Commission has done policy making a great disservice, since much of the policy debate, across all issues, includes references to competitive outcomes that are irrelevant to communications markets. In the *Phoenix Forbearance Order*, the agency falls victim to its own failing in this regard, establishing a "competitive level" entirely inconsistent with the economics of the industry. While in a few instances, including the *National Broadband Plan*, the Commission has embraced a more sensible and modern approach to competitive analysis, its advanced analysis in these few instances have not transferred reliably to other agency actions.[79]

Entry into telecommunications markets, especially facilities-based entry, requires significant fixed and sunk set-up costs, such as building a telecommunications network and the acquisition of customers through advertising. These costs drive industry structure. Like prices, the number of competitors in an industry is an equilibrium outcome. In many game theoretic models of industry structure, the entry process is modelled as a two-stage game, where in the first stage firms make entry (i.e., investment) decisions and, in the second stage, engage in price competition.[80] Firms are neither naïve nor stupid: they enter if and only if they reasonably expect the resulting industry structure to justify their sunk investments. These models provide important insights for forming sound competition and communications policy.[81]

These game-theoretic models expose the limitations of applying traditional competition analysis to the communications industries where entry costs are high. The implication is that the equilibrium market structure will always be relatively concentrated compared to industries where entry does not require substantial set-up costs.[82] The relationship between the number of firms and market power, where market power is defined as the ability of firms to price above *short-run* marginal cost, implies that that some communications firms will now, and in the future, possess some degree of market power. Thus, refusing to forbear in the presence of market power implies the agency will never forbear—*ever*. Also, these models show that high concentration may the result of intense price competition, rather than being an indicator of a

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79 *National Broadband Plan*, *supra* n. 56, at Section 4.2.

80 J. Sutton, SUNK COSTS AND MARKET STRUCTURE (1991); *see also* L. Phlips (ed.), APPLIED INDUSTRIAL ECONOMICS (1996), especially Chs. 1 and 2.

81 G.S. Ford, T.M. Koutsky and L.J. Spiwak, *Competition After Unbundling: Entry, Industry Structure and Convergence*, 59 FEDERAL COMMUNICATIONS LAW JOURNAL 331 (2007); J.B. Duvall and G.S. Ford, *Changing Industry Structure: The Economics of Entry and Price Competition*, 7 TELECOMMUNICATIONS AND SPACE JOURNAL 40 (2001); Sutton, *id*.

82 For a thorough theoretical analysis of equilibrium market structure, *see* W.J. Baumol and D. Fischer, *Cost-Minimizing Number of Firms and Determination of Industry Structure*, 92 Q. J. ECON. 439-67 (1978).

lack of it. The tradition view that more firms implies more competition must be qualified by the possibility that more competition implies fewer firms.

We suspect that many parties lament the fact that telecommunications markets will often be characterized by few competitors. Unfortunately, the current economic realities of the telecommunications market prescribe such an outcome, and little can be done to change it. However, a material change in perspective, from the short-run to the long-run, suggests a useful result. In the long-run, all inputs of production can be changed.[83] At the equilibrium industry structure, the entry condition indicates that profits are zero, and thus price equals long-run incremental cost. Consequently, the equilibrium industry structure, regardless of how concentrated it is, is broadly consistent with the competitive outcome (zero profits, price equals cost). If rates are to be just and reasonable, and thus non-confiscatory, then this equilibrium is the best the regulator can hope for. Absent collusion (which is largely the responsibility of the antitrust agencies), regulation cannot improve upon the competitive equilibrium. To do so, price would be set below cost, perhaps deterring entry in doing so.[84]

VII. The *Phoenix Forbearance Order* and "Title II Lite"

As noted above, as the Commission struggles to write a legally-sustainable set of Open Internet rules, there are significant calls for the Commission to reclassify broadband Internet access as a Title II common carrier telecommunications service. However, conceding the point that Title II regulation could slow innovation, there are a variety of proposals which ask the Commission to use its forbearance authority to forbear from many portions of Title II, ending

[83] The Commission's Total Element Long Run Incremental Cost ("TELRIC") standard is a long-run cost standard, where everything but the locations of the wire centers can be changed. Of course, the popular Long-Run Incremental Cost ("LRIC") standard is also a long-run cost concept.

[84] A similar argument has made in the context of antitrust in the brilliant book by L. Phlips, COMPETITION POLICY: A GAME-THEORETIC PERSPECTIVE (1995) at p. 11-2 ("I therefore am ready to argue that the competitive Nash equilibrium provides the equilibrium concept that [] defines the lower limit to which active competition should reduce industry prices or the upper limit to which active competition should push industry production. Once this limit is reached, no oligopolist has an incentive to break through it. … To reach a competitive Nash equilibrium of a single-shot game is the best antitrust policy can hope for in oligopolistic markets (which is a far reaching statement, given that most real life markets are oligopolistic). Therefore, if normal competition is the objective of antitrust policy, it should be defined as and have the properties of a competitive Nash equilibrium. Let me make this statement a bit more precise and insist that, given the multiplicity of possible Nash equilibria, I mean a 'perfect' competitive Nash equilibrium (in quantities or prices, according to the strategies chosen by the industry). Such a perfect Nash equilibrium is part of a two-stage equilibrium, in which the other stage implies a market structure that is endogenously determined by the given technology and given tastes.").

up with is colloquially referred to as "Title II Lite."[85] While the *Phoenix Forbearance Order's* "market power" test is most directly relevant to wholesale obligations, it is nonetheless important to ask whether the *Phoenix Forbearance Order* has any application to attempts to use Section 10 to create a "Title II Lite." After some consideration, we think that it does.

At the heart of the Commission's theory for imposing Open Internet rules is the agency's finding that Broadband Service Provider's ("BSP") have the ability and incentive to act in ways the slow the deployment of advanced communications networks because each is a "terminating monopoly" (i.e., each firm is "dominant").[86] In *Verizon v. FCC*, the D.C. Circuit agreed with this characterization of the BSP and laid out a clear path forward for the Commission to address this concern without having to engage in significant legal gymnastics[87]—an approach which the Commission embraced in its *2014 Open Internet Notice of Proposed Rulemaking*.[88] If the Commission were to adopt the Title II path for net neutrality rather than proceeding under Section 706, then the Commission must justify forbearance in the presence of a monopoly. Yet, the *Phoenix Forbearance Order* explicitly rejects forbearance in the presence of monopoly (and the agency has never forborne from price regulation in the presence of monopoly).[89] Thus, either forbearance is legitimate under monopoly and the *Phoenix Forbearance Order's* legal foundation falls (which would not be a bad thing) or the "Title II Lite" legal foundation falls.[90]

The Commission's path to Title II Lite does not ease even if we accept *arguendo* that the relevant market for net neutrality is the retail market (rather than the terminating market).[91] As

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85 For a full explanation of the legal validity and implication of these proposals, *see* G.S. Ford and L.J. Spiwak, *Tariffing Internet Termination: Pricing Implications of Classifying Broadband as a Title II Telecommunications Service,* PHOENIX CENTER POLICY BULLETIN NO. 36 (September 2014) (available at: http://www.phoenix-center.org/PolicyBulletin/PCPB36Final.pdf) *and forthcoming* 67 FEDERAL COMMUNICATIONS LAW JOURNAL; L.J. Spiwak, *Section 10 Forbearance Offers No Easy Path to "Title II Lite"*, THE HILL (October 21, 2014) (available at: http://thehill.com/blogs/pundits-blog/technology/221342-section-10-forbearance-offers-no-easy-path-to-title-ii-lite); *see also,* G.S. Ford, L.J. Spiwak and M. Stern, *The Broadband Credibility Gap*, 19 COMMLAW CONSPECTUS 75 (2010).

86 *In re Preserving The Open Internet,* FCC 10-201, 25 FCC Rcd 17905, REPORT AND ORDER (rel. December 23, 2010).

87 *Verizon v. FCC*, 740 F.3d 623 (D.C. Cir. 2014); *see also* L.J. Spiwak, *What Are the Bounds of the FCC's Authority Over Broadband Service Providers? A Review of the Recent Case Law,* PHOENIX CENTER POLICY BULLETIN NO. 35 (June 2014) (available at: http://www.phoenix-center.org/PolicyBulletin/PCPB35Final.pdf).

88 *2014 Open Internet NPRM, supra* n. 9.

89 *See* discussion *supra* in Section V.B.

90 See *Tariffing the Internet: A Response to Harold Feld*, @LAWANDECONOMICS BLOG (October 9th, 2014) (available at: http://phoenix-center.org/blog/archives/1928).

91 *Id.; Tariffing the Internet, supra* n. 85.

noted above, in the *Phoenix Forbearance Order,* the Commission deliberately refused to accept wireless as a legitimate competitive substitute for wireline access and, as such, found that there were only two wireline firms—i.e., a duopoly—in each market. For purposes of Section 10 forbearance, the Commission specifically held that it was inappropriate to assume that

> a duopoly always constitutes effective competition and is necessarily sufficient to ensure just, reasonable, and nondiscriminatory rates and practices, and to protect consumers. The potential for supracompetitive prices may be a concern where there is a duopoly or a market dominated by a few firms and there are high barriers to entry into the market.[92]

Accordingly, the Commission found that "the move from monopoly to duopoly is not alone necessarily sufficient to justify forbearance….",[93] and the 10th Circuit affirmed the agency's logic.[94] Combining the Commission's holding in the *Phoenix Forbearance Order* that two firms are insufficient to warrant forbearance with a recent FCC analysis which found that that "[a]t the current FCC benchmark for high-speed Internet service … the majority of Americans have a choice of only two providers",[95] the use of Section 10 forbearance to create a "Title II Lite" would be a hard sell to a reviewing court.[96] Importantly, the "duopoly" issue is relevant to the

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92 *Phoenix Forbearance Order, supra* n. 6 at ¶ 29.

93 *Id.* at ¶ 30.

94 *Supra* n. 6.

95 *Fact Sheet: More Competition Needed in High-Speed Broadband Marketplace* (September 4, 2014) (available at: https://apps.fcc.gov/edocs_public/attachmatch/DOC-329160A1.pdf); *see also* Prepared Remarks of FCC Chairman Tom Wheeler, "The Facts and Future of Broadband Competition", 1776 Headquarters, Washington, D.C. (September 4, 2014) (available at https://apps.fcc.gov/edocs_public/attachmatch/DOC-329161A1.pdf). According to FCC Chairman Tom Wheeler, "[m]eaningful competition for high-speed wired broadband is lacking [because] the majority of Americans have a choice of only two providers." In fact, Chairman Wheeler stated that "even two 'competitors' overstated the case."

96 Significantly, in 2012 the Commission released a *Report and Order* suspended, on an "interim" basis, its rules for automatic grants of pricing flexibility for special access services "in light of significant evidence" that the current deregulatory trigger—i.e., two competitors have collocated in a single Metropolitan Statistical Area—is "not working as predicted." In particular, the Commission found that the geographic territories contained in most MSAs are "overly broad" and, in contrast, most competitive entry is occurring only in areas with "extremely concentrated demand." However, if the Commission grants forbearance in the face of a "terminating monopoly", then its efforts to impose regulation in the Special Access context must fall. *See In the Matter of Special Access for Price Cap Local Exchange Carriers; AT&T Corporation Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services,* FCC 12-92, 27 FCC Rcd 10557, REPORT AND ORDER (rel. August 22, 2012) (available at: https://apps.fcc.gov/edocs_public/attachmatch/FCC-12-92A1.pdf); G.S. Ford and L.J. Spiwak, *Set It and Forget It? Market Power and the Consequences of Premature Deregulation in Telecommunications Markets*, 3 NYU JOURNAL OF LAW AND BUSINESS 675 (2005).

retail and not the terminating market (the latter of which the Commission claims is a monopoly). Classifying broadband as a Title II service, therefore, may—under the competitive analysis of the *Phoenix Forbearance Order*—unavoidably lead to the price regulation of all retail broadband services.[97]

VIII. Conclusion and Policy Recommendations

The Telecommunications Act of 1996 aimed to "provide for a pro-competitive, *de-regulatory* national policy framework" for the nation's communications markets. While the 1996 Act included a number of regulations designed to promote competition, these burdensome schemes, including network unbundling, were intended to be short-lived and eventually set aside by the Commission using its Section 10 forbearance authority. Dismantling the meager remnants of the Act's unbundling regime has proven difficult for the agency. Faced with the essentially same evidence from the same petitioner across two proceedings, the Commission reached two entirely opposite conclusions, forbearing from much of the unbundling mandates in 2005 but refusing to grant any relief in 2009. The agency's 2009 decision—the *Phoenix Forbearance Order*—was a mess, asking the wrong questions and bungling the economics of the industry. Nevertheless, the *Phoenix Forbearance Order* serves as a useful template for outlining how the agency can improve its forbearance analysis going forward.

Perhaps the most important lesson learned from the *Phoenix Forbearance Order* is that when contemplating forbearance from any regulation or mandate, the first and most-important step is to ask the right question. That is: *does removing the regulation make society worse off?* It is this question that drives the analysis and gives meaning to the empirical evidence. This simple question points to a cost-benefit analysis in which the agency considers the purpose of the regulation, provides an honest assessment of the efficacy of it (including the compliance costs and unintended consequences of the regulations), and then decides how much competition, if any, is sufficient to accomplish the same goal. In its *Phoenix Forbearance Order*, the Commission failed to ask the right question (among many other errors), focusing instead on a comparison of the observed level of competition to some unobtainable competitive nirvana and did so for a phantom market. This primary error led the agency far astray from its assigned task, and has unfortunately established a poor precedent for future forbearance petitions. Fortunately, the

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[97] For a full exploration of this point, *see* G.S. Ford, *Title II Reclassification and the Price Regulation of Retail Broadband Services*, @LAWANDECONOMICS BLOG (October 30, 2014) (available at: http://phoenix-center.org/blog/archives/1958). This notion of potential retail broadband price regulation is not farfetched. As we pointed out in our paper *The Broadband Credibility Gap, supra* n. 85, several years ago the agency released a much-promoted consumer survey that found that the optimal price for retail broadband service was around $25. However, "affordability" is not a recognized criterion under Section 201 or 201 of the Communications Act.

Commission can change, and has changed, its mind on how it makes forbearance decisions. Hope springs eternal.

In addition, we discuss the relevance of the *Phoenix Forbearance Order* for the current net neutrality debate and the reclassification of broadband as a Title II telecommunications service. We conclude that the *Phoenix Forbearance Order*—by rejecting the use of forbearance under monopoly and duopolistic competition—stands in the way of using forbearance to create a "Title II Lite" form of regulation. In fact, if broadband is classified as a Title II service, then for the first time in history the Commission must regulate the retail prices of broadband connections.

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