

Network Access Rates for Competitive Rural Local Exchange Carriers A Critical Reexamination of the CLEC Access Orders

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This paper is one of a series of papers outlining the unique operating characteristics of Competitive Local Exchange Carriers competing in small rural communities and the impact of regulation on these operations. Such companies are referred to as “RLECs,” or competitive Rural Local Exchange Carriers.

RLEC regulation, like regulation in the telecommunications industry in general, is undergoing rapid change. Unfortunately, the limited number of RLECs and their lack of participation in the regulatory process to date is causing many of the unique RLEC issues to be overlooked, often times to the extent that federal and state regulatory decisions produce results in small community markets that are directly contrary to stated regulatory goals. It is the author’s hope that these papers will provide the industry with the information necessary to reevaluate and adjust regulatory approaches in RLEC markets. Except as otherwise specifically noted, the analysis and conclusions in these papers are those of the author and do not necessarily represent the views of the author’s company.

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Abstract

The rise of competitive rural local exchange carriers (“RLECs”) began with the enactment of the Telecommunications Act of 1996. As early as 1997, RLECs began operating in small rural community markets by building their own proprietary networks complete with direct customer premise connections to compete with the much larger incumbents who had allowed their service plant to deteriorate, resulting in poor service quality and local customer support. As such, RLECs share much more in common with their small community, rate-of-return ILEC cousins than they do with their large incumbent rivals or with the development of the metropolitan area, reseller-based CLEC companies and, as will be demonstrated below, this has resulted in many problems for RLECs in coping with CLEC access rate regulation.

The Federal Communications Commission (the “Commission”) recognized very early that a major key to establishing competition in telecommunications is the requirement of mandatory interconnection of competing networks. Mandatory interconnection removes substantial barriers to entry into telecommunications markets and increases the value of any one company’s network to the company, its competitors and its customers. However, mandatory interconnection also introduces the problem of just compensation to the individual network owners.

The Commission initially addressed the compensation issue by finding that the use of forward looking economic costs provides the best method for establishing fair interconnection and network access rates, a conclusion also implemented by many states. Unfortunately, the Commission later abandoned these economic findings by adopting CLEC network access rate caps based on incumbent access rates on the assumption that incumbent rates were representative of market prices and therefore fair and equitable. While this may be true for large CLECs competing with incumbent RBOCs on a resale basis in metropolitan areas, it is not true for facilities-based RLECs in their small rural community markets. There is no market for network access in RLEC communities, and incumbent rates are not set based on market conditions. Rather, incumbent rates are based on cost studies that unfairly average low cost, high-density areas with the far more expensive rural areas, an averaging process that RLECs cannot match. As a result, the Commission’s CLEC access orders have forced RLECs to cap their access rates at levels far below their actual costs. This is causing cross subsidization of incumbents and other competitors, interfering with company cost structures and efficient consumer pricing (leading to higher consumer prices), distorting the economic market signals for capital investment, and slowing down market entry, innovation and competition in rural markets.

The Commission attempted to ameliorate these results with the “Rural Exemption.” However, this exemption is so narrowly drawn that it is not providing the relief necessary in the small community environment in eastern South Dakota, southwestern Minnesota and northwestern Iowa where PrairieWave operates due to the central adjacent location of Sioux Falls, South Dakota, a small community of approximately 140,000.

The solution to these problems lies not in an arbitrary exemption or proxy access rates, but in a return to the use of company specific forward looking economic cost studies to establish network access rates, at least for RLECs. This would result in access rate regulation similar to the rural community rate-of-return ILECs. The waiver process is one appropriate procedural mechanism for implementing this approach, allowing RLECs to choose the existing rate caps or to adopt the accounting policies necessary to support forward looking economic cost studies.

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Introduction

1. PrairieWave Telecommunications, Inc. (“PrairieWave”) pioneered the RLEC overbuild planning and implementation process in 1996. By 1998, it operated the largest competitive Hybrid Fiber Coax (“HFC”) network in the country. By 2000, it had committed to overbuild 19 additional communities, and has completed all but a small portion of one community. Today it is one of the largest RLECs in the country focusing exclusively on small, rural communities. But its ability to continue to expand into new rural markets has been curtailed by the Commission’s CLEC network access rate policies, first adopted in 2001,¹ which have set price caps that are far below PrairieWave’s costs of network operations. As a result, PrairieWave is subsidizing interstate network access for the very incumbents it set out to compete with and finds itself in the middle of a highly unfair situation of access revenue arbitrage and gaming of the system in favor of its competitors. This has made further expansion into new rural markets largely uneconomic given today’s capital markets.²

2. With the filing of PrairieWave’s interstate access tariff and supporting forward-looking economic cost study, the Commission is provided for the first time with factual evidence³ demonstrating that the application of incumbent access rate caps to companies operating in small communities and rural markets contravenes the competitive goals set by Congress in the Telecommunications Act of 1996⁴ and by the Commission in promulgating rules pursuant to the 96 Act.

3. This paper summarizes the economic theory underlying the Commission’s competitive decision-making process, examines this theory as it has unfolded in the historical record of the Commission’s deliberations since 1996, and explains why, using the Commission’s own analysis, the use of forward looking economic costs is appropriate for RLECs in today’s competitive environment. In so doing, it will also demonstrate why the rate caps imposed by the current CLEC Access Orders are inapplicable to RLECs, both theoretically and in actual

¹ *Access Charge Reform*, Seventh Report and Order, CC Docket No. 96-262, 16 FCC Rcd 9923 (2001) (“CLEC Access Order I”); *Access Charge Reform*, Eighth Report and Order, CC Docket No. 96-262, 19 FCC Rcd 9108 (2004) (“CLEC Access Order II”). The resulting rate/cost disparity has caused PrairieWave to cease further expansion into new rural markets. See Note 122 and the accompanying text *infra*.

² See Note 122 and discussion at ¶¶ 80, 84, 90, 97, 104 *infra*. As discussed in detail in these paragraphs, under current regulation, RLEC access rates are forced substantially below cost, causing a fundamental pricing distortion that directly results in inefficient capital investment signals.

³ The Commission’s consideration of CLEC access rates has been marked by a frustrating lack of hard cost data, especially in the RLEC area. See, for example, *AT&T Corp v. Business Telecom, Inc.* Memorandum Opinion and Order, EB-01-MD-001 and EB-01-MD-001, 16 FCC Rcd 12312 (2001) (“BTI Order”). See, also, the accompanying text and analysis in Notes 94 and 125 *infra*. At the time of CLEC Access Order I, PrairieWave, then known as Dakota Telecommunications Group, was controlled by a large UNE-based CLEC that had no appreciation of the need for cost study analysis and prevented Dakota’s management from participating in the Commission’s proceedings.

⁴ *Telecommunications Act of 1996*, Pub. L. No. 104-104, 110 Stat. 56 (1996) (the “96 Act”). The 96 Act amended the Communications Act of 1934 (Act). 47 U.S.C. §§ 151 *et seq.*

practice. While using PrairieWave's situation as an exemplar for this analysis, the general economic theories discussed in this paper as well as the problems created for competition in rural communities are applicable in general to all RLECs in the country.

The Foundation of Telecommunications Competition

4. The stated goal of the 96 Act is to promote competition in the telecommunications industry.⁵ This reflects the recognition by Congress and the Commission that both consumer pricing and service innovation is best improved through the operations of the market economy,⁶ a conclusion supported by virtually all of the economists writing in this area.⁷

5. To meet this objective, the Commission established the following goals to guide its rule making process:

- To encourage market entry by competitive service providers.⁸
- To reduce the risks of market entry to new entrants.⁹
- To encourage efficient levels of investment by eliminating regulatory arbitrage opportunities.¹⁰ “While we seek to promote competition among local-service

⁵ . “Our actions are consistent with prior Commission actions to foster competition and efficient pricing in the market for interstate access services, and to create universal service mechanisms that will be secure in an increasingly competitive environment.” *In the Matter of Access Charge Reform for Incumbent Local Exchange Carriers Subject to Rate-of-Return Regulation*, First Report and Order, CC Docket 98-77, 16 FCC Rcd 19613 (2001) (“ILEC Access Order,” also often referred to by the Commission as the “MAG Order”), ¶ 3.

⁶ “[Our actions] are designed to bring the American public benefits of competition and choice by rationalizing the access rate structure and driving per-minute rates towards lower, more cost-based levels, while furthering universal service goals.” *Id.* at ¶ 1. “...a market-based approach which relies primarily on competition to drive access charges down to cost-based levels generally would serve the public interest better than prescribing rates.” *Id.* at ¶ 24.

⁷ Richard A. Posner, *Natural Monopoly and its Regulation* (Cato Institute 1999), pp. 4, 19. *See, also*, Stephen Breyer, *Regulation and Its Reform* (Harvard University Press 1982), p.299; Bridger M. Mitchell and Ingo Vogelsang, *Telecommunications Pricing, Theory and Practice* (Cambridge University Press 1991), p. 5; and Kevin G. Wilson, *Deregulating Telecommunications* (Rowman & Littlefield Publishers, Inc. 2000), pp. 43-44. Wilson presents the FCC's decisions in the satellite communications dockets as another example: “The presence of competitive sources of supply of specialized services, both among satellite system licensees and between satellite and terrestrial systems, should encourage service and technical innovation and provide the impetus for efforts to minimize costs and charges to the public.” *Id.* at pp. 133-134, quoting the FCC decision in *Domestic Communications-Satellite Facilities (DOMSATII)*, Second Report and Order, 35 FCC 2d 844 (1972a).

⁸ *In the Matter of the Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, CC Docket No. 96-98, 11 FCC Rcd 15499 (1996), ¶ 378 (“Local Competition Order”). *See, also*, CLEC Access Order I, ¶¶ 6, 33.

⁹ Local Competition Order, ¶ 378.

¹⁰ CLEC Access Order I, ¶¶ 3, 33, 122; Local Competition Order, ¶ 672.

providers, we also seek to eliminate from our rules opportunities for arbitrage and incentives for inefficient market entry.”¹¹

6. PrairieWave agrees with these goals and with the overall objective of using market forces to encourage innovation, set prices, and therefore properly signal the allocation of investment capital in the industry. PrairieWave believes that these goals are widely accepted throughout the industry, and that its own investment and entry in numerous small community markets from 1997 through early 2001 provides excellent real world proof that market forces can encourage competition and bring the benefits of competition to rural consumers.

7. However, the unique prerequisites of telecommunications competition—that of mandatory interconnection between competing carriers and the resulting access compensation issues—have been applied in a way that is fundamentally unfair to RLECs in general and PrairieWave in particular and, if continued, these rules will ultimately undercut the Commission’s competitive goals and objectives in small and rural communities.

Mandatory Interconnection and the Ubiquitous Network Requirement

8. In its Local Competition Order, the Commission ordered that “...the incumbent LEC must provide interconnection in accordance with Section 251(c)(2) and the Commission’s rules thereunder to any telecommunications carrier, including interexchange carriers and commercial mobile radio service (CMRS [what we now know as cellular companies]) providers.”¹² The Commission further ordered that interconnection and network access “...must be equal in quality to that provided by the incumbent LEC to itself or its affiliates, and must be provided on rates, terms, and conditions that are just, reasonable, and nondiscriminatory.”¹³

9. Mandatory interconnection of all competitive service providers is necessary to introduce and maintain a competitive telecommunications industry because it is only through nationwide interconnection that a company can maximize network value. This is so for three reasons. First, it is socially desirable to connect as many users as possible to a network that allows each user to communicate with all others. This is, in fact, the underlying drive behind the industry’s long-standing commitment to universal service.¹⁴ Second, as a purely economic matter, any one company’s network value is exponentially increased if it is interconnected with all other networks both with respect to the individual service provider involved and to the users of the networks. Finally, and largely as a result of the foregoing reasons, the lack of interconnection operates as a substantial barrier to entry for new competitors.

10. Kevin G. Wilson, an expert economist in this area, writes as follows:

¹¹ CLEC Access Order I, ¶ 33.

¹² Local Competition Order, ¶¶ 26, 181, 213, 217.

¹³ *Id.* at ¶¶ 26, 224, 315, 316.

¹⁴ See Mitchell and Vogelsang, *Telecommunications Pricing, Theory and Practice*, p. 224.

“In a communications network, such as the telephone network, the value of the network to all subscribers increases as the number of subscribers increases. A network that enables a caller to reach millions of potential subscribers is infinitely more useful and, therefore, valuable than one that reaches only ten subscribers.”¹⁵

11. William Sharkey explains it this way:

“A potential subscriber receives a benefit from joining the network that depends on both the number of other users, most of whom are unknown initially, and the identity of specific users who are already in the system. That is, a communications service is valuable in that it allows communication with a large number of people and because it allows more frequent contact with a smaller number of close friends. ...A telephone network benefits all those who subscribe by lowering the costs of communication among its members.”¹⁶

12. In fact, it was the threat of prohibiting interconnection between competitive and even noncompetitive telephone companies that triggered the initial regulation of the industry in the late 1880s.¹⁷ It continued as a key issue in the MCI decisions in 1974, the Southern Pacific Communications decision in 1978, and in the Mid-Texas Communications Systems litigation, all court challenges to the failure to provide necessary network interconnection.¹⁸

13. Congress recognized the importance of ubiquitous communications networks in the preamble to the Communications Act of 1934 where it established the Commission “For the purpose of regulating interstate and foreign commerce in communication by wire and radio *so as to make available, so far as possible, to all the people of the United States a rapid, efficient, Nation-wide and world-wide wire and radio communication service* with adequate facilities at reasonable charges...”¹⁹ [Emphasis added]

14. The Commission has long acknowledged the need for local interconnection in establishing competitive telecommunications services.²⁰ It specifically recognized this value in the CLEC Access Order I:

¹⁵ Wilson, *Deregulating Telecommunications*, p. 58.

¹⁶ William W. Sharkey, *The Theory of Natural Monopoly*, Cambridge University Press (1982) at p. 187. See, also, Amy Friedlander, *Natural Monopoly and Universal Service* (Corporation for National Research Initiatives, 1995), pp. 49-50, 80, and Mitchell and Vogelsang, *Telecommunications Pricing, Theory and Practice*, p. 11.

¹⁷ Wilson, *Deregulating Telecommunications* at pp. 16-18, 20, 53, 71.

¹⁸ *Id.* at p. 138.

¹⁹ Quoted in Wilson, *Deregulating Telecommunications* at p. 62.

²⁰ An example: “In the *Specialized Common Carrier* decision the FCC anticipated the need for local connections. It expected the established carriers to provide these circuits upon request and on reasonable terms.” Wilson, *Deregulating Telecommunications* at p. 127. And, again, in the satellite communications area: “The competitive satellite operators were dependent on AT&T for local distribution, and as a result, subject to the same kinds of

“In the Local Competition Order, the Commission found that a section 251(a)(1) duty to interconnect, directly or indirectly, is central to the Communications Act and achieves important policy objectives. ...We agree that universal connectivity is an important policy goal that our rules should continue to promote. The public has come to value and expect the ubiquity of the nation’s telecommunications network. Accordingly, any solution to the current problem that allows IXCs unilaterally and without restriction to refuse to terminate calls or indiscriminately to pick and choose which traffic they will deliver would result in substantial confusion for consumers, would fundamentally disrupt the workings of the public switched telephone network, and would harm universal service.”²¹

15. In fact, the value created by network economies in telecommunications is so powerful that it is has frequently been used as a barrier to entry and the anticompetitive weapon of choice for the incumbent Bell companies.²²

16. Mandatory interconnection is an obvious example of Congress and the Commission acting to meet the first two goals for establishing competition in the telecommunications industry namely, to encourage competitive entry and remove obstacles to such entry. However, mandatory interconnection brings with it an associated problem—the proper way to compensate companies for the taking of their networks for use by others. Here the Commission has examined three possible solutions: the use of market rates, the use of bilateral negotiated rate agreements, and regulatory rulemaking. PrairieWave believes that the Commission has properly adopted the rulemaking alternative, but has adopted CLEC access rate rules that do not reflect the reality of RLEC competitive operations.

Market Based Network Access Rates

17. It is widely accepted that where access rates can be established through the workings of an unencumbered and free market, those rates would be preferred.²³ This is, after all, the major rationale for deregulating the industry and introducing competition into the setting of consumer

delays and interconnection problems that had plagued the microwave specialized common carriers.” *Id.* at p. 135. The courts have similarly recognized this requirement: “...our emphasis on tariffs and rate making as the exclusive means for future limitations on the specialized carriers’ development clearly contemplated that the carriers would be free to expand their service offerings—**and would be afforded the necessary interconnections**—until and unless it was found that the public interest demanded otherwise.” *MCI v. FCC*, 580 F.2d 590 D.C. Cir. 1978 as quoted in Wilson, *Deregulating Telecommunications* at p. 129. [Emphasis added].

²¹ CLEC Access Order I, ¶¶ 92 and 93. *See, also*, CLEC Access Order I, ¶ 24. This finding was reiterated in CLEC Access Order II at ¶ 61.

²² Friedlander, *Natural Monopoly and Universal Service*, pp. 2, 61, 68-71, 74-75. *See, also*, the discussion in ¶12 and the accompanying footnotes *supra* and, especially, the Commission’s own conclusions supporting this position in the ILEC Access Order proceedings discussed beginning at ¶ 91 *infra*.

²³ *See* Wilson, *Deregulating Telecommunications* at pp. 43-44.

rates.²⁴ Unfortunately, network access rates cannot be set by market forces, and for some very good reasons.

Regulatory Artificialities and CLEC Network Access Rates

18. It is critical to keep in perspective that the network access rate issue is itself a regulatory artificiality caused by the direct interference with the normal market mechanisms, in this case by imposing mandatory network interconnection.²⁵ While interconnection is both necessary and desirable in order to create opportunities for competitive market entry, the reasons for making interconnection mandatory means that the market is unable to operate in this area. The very rights that mandatory interconnection creates—mutual network access—it creates by an economic taking, the value of which varies based on each participant’s actual costs (which, as we will see later, varies due to specific market characteristics including demographic density, topography, and system technologies).²⁶ The proper solution must therefore consider these factors, and must recognize that no natural market exists to provide the solution. For if it were otherwise, *mandatory* interconnection would not be necessary. In creating the groundwork for an effective competitive market in retail consumer services, the Commission has simultaneously created a problem that cannot be solved by the private sector, itself a demonstration of the need for continued regulation in this particular area.²⁷

The [Nonexistent] Network Access Market

19. The network access market is not competitive. In fact, as a practical matter, there is no functioning network access “market” at all, especially in RLEC communities. PrairieWave is not aware of a single competitive access provider that now operates, or has operated, in any of its small community markets. The reason is two-fold: (1) the CLEC Access Orders have created an economic environment where the access rate caps are far below actual costs, effectively preempting market entry (which is the very point of PrairieWave’s tariff filing), and (2) there is no practical way for a true access market to develop, let alone generate effective access rate price signals.

²⁴ “Underscoring the practice of public utility regulation was the premise that the goal of regulation was essentially to mimic competitive conditions. In other words, one could say that the goal of regulation should be to produce competitive results...” Wilson, *Deregulating Telecommunications* at p. 61.

²⁵ Breyer notes that regulatory “...intervention is not costless. Moreover, intervention—or rearrangement of rights and liabilities—changes the distribution of wealth and income.” Breyer, *Regulation and Its Reform*, p.25. This is exactly what occurred with the decision to impose mandatory interconnection.

²⁶ See the discussion of the problems with using average costs beginning at ¶ 29 *infra*.

²⁷ Even Richard Posner, one of the foremost critics of telecommunications regulation, recognizes that “The resources and energies of government should be directed to problems that we know are substantial, that we think are tractable to government action, and *that cannot be left to the private sector to work out.*” Posner, *Natural Monopoly and its Regulation*, p. 109. Posner also predicted the possibility that the deregulation process itself could result in unintended consequences: “Regulatory efforts to eliminate monopoly profits may, therefore, if effective, often create fresh distortions in resource allocation.” *Id.* at p. 69. This is exactly what is now occurring in the rural community RLEC markets. See text beginning at ¶ 78.

20. The Commission considered this last point in great detail in the CLEC Access Order I:

“CLEC use of this [tariff filing] strategy raises questions about the extent to which CLECs truly are subject to competition in their provision of access service. The Commission has previously noted the unique difficulties presented by the case of terminating access, where the called party is the one that chooses the access provider, but it neither pays for terminating access service, nor does it pay for, or choose to place, the call. It further complicates the case of terminating access that an IXC may have no prior relationship with a CLEC, but may incur access charges simply for delivering a call to the access provider’s customer. In these circumstances, providers of terminating access may be particularly insulated from the effects of competition in the market for access services. The party that actually chooses the terminating access provider does not also pay the provider’s access charges and therefore has no incentive to select a provider with low rates.”²⁸

“On further consideration, it appears that the CLECs’ ability to impose excessive access charges is attributable to two separate factors. First, although the end user chooses her access provider, she does not pay that provider’s access charges. Rather, the access charges are paid by the caller’s IXC, which has little practical means of affecting the caller’s choice of access provider (and even less opportunity to affect the called party’s choice of provider) and thus cannot easily avoid the expensive ones. Second, the Commission has interpreted section 254(g) to require IXCs geographically to average their rates and thereby to spread the cost of both originating and terminating access over all their end users. Consequently, IXCs have little or no ability to create incentives for their customers to choose CLECs with low access charges. Since the IXCs are effectively unable either to pass through access charges to their end users or to create other incentives for end users to choose LECs with low access rates, the party causing the costs – the end user that chooses the high-priced LEC – has no incentive to minimize costs. Accordingly, CLECs can impose high access rates without creating the incentive for the end user to shop for a lower-priced access provider.

“We now acknowledge that the market for access services does not appear to be structured in a manner that allows competition to discipline rates.”²⁹
[Emphasis added]

21. There is a powerful economic reason why this is the case. The value of the ubiquitous network does not “...play a part in the individual user’s decision to subscribe, or more

²⁸ CLEC Access Order I, ¶ 28.

²⁹ *Id.* at ¶ 31. *See, also*, CLEC Access Order I, ¶ 29.

importantly not to subscribe, to the service.”³⁰ Put another way, the inability of individual subscribers to recognize the value of a ubiquitous network leads to what economists term the “free rider” problem. In the context of network access, it simply means that retail subscribers will not create the proper demand and pricing signals to establish a competitive market price for network access.³¹

Incumbent Access Rates Are Not RLEC Market Rates

22. From the foregoing, it is apparent that incumbent access rates are not market prices and are not set through the operation of a competitive market. This is especially true in RLEC markets for several reasons.

Incumbent Market Definition and Cost Averaging

23. One of the major problems with applying incumbent access rates to RLECs is that the incumbent rates are not defined using the same market area. Both the size and location(s) of the “markets” used to establish incumbent access rates (known as “Study Areas”) are not congruent. In fact, there is a major mismatch between the markets in which the RLECs operate and the markets used to set ILEC rates.

24. Incumbents, especially the RBOC incumbents that most RLECs compete against, enjoy an unfair advantage due to their size and their ability to spread their network costs over a larger subscriber base in denser, less costly markets. This means that using incumbent access rates as benchmark rates for RLECs is an unreasonable and analytically flawed comparison, as demonstrated by PrairieWave’s filing.³² As the CLEC Access Order I explains:

“Limiting CLECs to the higher of the benchmark rate or the access rate of its ILEC competitor could prove rather harsh for some of the small number of CLECs that operate in rural areas. The difficulty would likely arise for those CLECs that operate in a rural area served by a price-cap incumbent with state-

³⁰ Wilson, *Deregulating Telecommunications*, pp. 58-59.

³¹ See Sharkey, *The Theory of Natural Monopoly*, at p. 46: “...an individual may understate his or her value of the good and enjoy consumption without paying the proper price, or in extreme cases, without paying anything at all. This phenomenon [is] known as the “free-rider” problem...” As we shall later see, this is exactly what is occurring in the access markets PrairieWave’s small communities as the use of incumbent access rate caps results in PrairieWave’s competitors enjoying a subsidized “free ride” over PrairieWave’s network. See the text and accompanying notes beginning at ¶ 85 and then, again, at ¶ 96 *infra*.

³² See *Petition of PrairieWave Telecommunications, Inc. for Waiver of CLEC Access Charge Rule*, CC Docket 96-262, filed November 2004 (the “PrairieWave Petition”) at ¶ 6: “PrairieWave has prepared a FLEC study for the Commission to review and to provide the economic basis for its proposed access charges. The study demonstrates that the cost-based, per-minute switching rate for the interstate jurisdiction to be \$0.014942 and for transport \$0.035937, for a composite per minute rate of \$0.050879. The comparable NECA rates for the ILEC are \$0.019328 for switching and an effective ILEC per minute average rate for transport of \$0.034913, for a composite rate of \$0.054241. The composite rate for the incumbent Qwest for all elements is \$0.0066, which is the rate PrairieWave is obliged to charge effective June 20, 2004 pursuant to CLEC Order I and as codified in 47 C.F.R. ¶ 61.26(c). The difference in the cost-based pricing, whether demonstrated by the FLEC study or the NECA tariff, and the arbitrarily selected incumbent benchmark, is staggering.”

wide operations. Our rules require such ILECs to geographically average their access rates. This regulatory requirement causes these “non-rural ILECs” effectively to use their low-cost, urban and suburban operations to subsidize their higher cost, rural operations, with the effect that their state-wide averaged access rates recover only a portion of the ILEC’s regulated costs for providing access service to the rural portions of its study area. During the course of this proceeding, we became concerned that tying the access rates of rural CLECs to those of such non-rural ILECs could unfairly disadvantage CLECs that lacked urban operations with which they could similarly subsidize their service to rural areas.”³³

25. The Commission has previously recognized that rural carriers face very different economics than larger LECs:

“...rural carriers are significantly different from non-rural carriers, and that individual rural carriers vary widely from each other. Rural carriers generally serve more sparsely populated areas and fewer large, high-volume subscribers than non-rural carriers. The isolation of rural carrier service areas creates numerous operational challenges, including high loop costs, high transportation costs for personnel, equipment, and supplies, and the need to invest more resources to protect network reliability. In addition, rural carriers generally have fewer customers per switch, higher total investment in plant per loop, and higher plant specific expenses per loop than non-rural carriers, all of which may vary dramatically depending on how many lines they serve.”³⁴

“...rural competitive LECs experience higher costs, particularly loop costs, and may lack the lower cost urban operations that non-rural incumbent LECs use to subsidize rural operations.”³⁵

26. PrairieWave believes that these differences require the Commission to return to its consideration of company specific forward looking economic access costs in setting RLEC rates, and demonstrates the inapplicability of large incumbent access rate as proxy rate caps. This is exactly what the Commission decided in the ILEC Access Order:

“The Commission also has considered proposals for adoption of a target rate for the per-minute access charges of rate-of-return carriers, either on an optional or a mandatory basis. The Commission rejects these proposals and concludes that none of these proposals is supported by cost data and that the non-prescriptive, market-based approach to access charge reform adopted in the Order is more

³³ CLEC Access Order I, ¶ 64.

³⁴ ILEC Access Order, ¶ 28.

³⁵ CLEC Access Order II, ¶30. “BINGO,” as they say in downtown Irene, South Dakota.

consistent with the competitive and universal service goals of the 1996 Act. The comments filed in this proceeding indicate a wide variation in cost patterns, density, and other operational characteristics among rate-of-return carriers. The access charge reform approach adopted in this Order accommodates this diversity by reallocating costs and removing implicit support to create more efficient rate structures, while allowing carriers to establish rates based on their own costs.”³⁶

27. Here is where the direct comparison between small rate-of-return ILECs and RLECs comes into focus. The use of incumbent access rates to set rate caps might be appropriate when the CLEC in question operates in a large metropolitan area with a comparable cost basis or operates using the incumbent’s underlying network elements or on a resale basis. In this situation, the use of incumbent rates is likely the best “market based” surrogate, a conclusion that the Commission actually adopted in the CLEC Access Order I:

“...in setting the level of our benchmark, we seek, to the extent possible, to mimic the actions of a competitive marketplace, in which new entrants typically price their product at or below the level of the incumbent provider. We conclude that the benchmark rate, above which a CLEC may not tariff, should eventually be equivalent to the switched access rate of the incumbent provider operating in the CLEC’s service area.”³⁷

28. But extending this analysis to RLECs operating in small, high cost communities is inherently unfair. In rural parlance: It is comparing “apples and oranges.” Moreover, as noted above, it is simply erroneous because *there is no competitive access market between incumbents and RLECs, making rate competition a myth and exposing a fatal flaw in the Order’s conclusion that incumbent access rates are somehow “market” rate, at least for RLEC markets.*³⁸

Average Costing is Not Appropriate for Market Specific RLEC Access Rates

29. It is worthwhile to pause and consider the additional problems of using average costing to set rates. The Commission has also investigated this area in great depth.

30. “[G]eographic averaging is simple to administer and prevents unreasonable or unlawful rate differences but, *where averaging covers high and low cost areas, it could distort competitors’ decisions whether to ...build their own facilities.*”³⁹ [Emphasis added] The Commission decided that simplification of rate determination via cost averaging is not in itself justified or appropriate. “We agree with most parties that deaveraged rates more closely reflect

³⁶ ILEC Access Order, ¶ 324.

³⁷ CLEC Access Order I, ¶ 42.

³⁸ See the discussion beginning at ¶ 19 *supra*.

³⁹ Local Competition Order, ¶ 758.

the actual costs of providing interconnection... Thus, we conclude that rates for interconnection ... must be geographically deaveraged.”⁴⁰ And again, later in the Order: “...[W]e believe that cost-based rates should be implemented on a geographically deaveraged basis.”⁴¹

31. The Commission acknowledged this same issue in analyzing CLEC network access rates. “We acknowledged that CLEC access rates may, in fact, be higher due to the CLECs' high start-up costs for building new networks, their small geographical service areas, and the limited number of subscribers over which CLECs can distribute costs.”⁴² With regard to the small rate of return ILECs, the Commission even quantified the problem of operating in largely rural areas:

“For example, our forward-looking economic cost model shows that the cost of providing a local loop in a rural area may be approximately one hundred times greater than the cost in an urban area.”⁴³

32. As will be discussed in more detail below, these very types of cost variances have resulted in rates that are far below actual forward looking economic costs, leading to significant market distortions.⁴⁴

33. The Commission specifically considered the impact of geographic cost and rate differences on the nondiscrimination standards of the 96 Act and found them to be perfectly in compliance. The Commission concluded: “Where costs differ, rate differences that accurately reflect those differences are not discriminatory.”⁴⁵ This was specifically reaffirmed in the CLEC Access Order I: “...this Commission has twice ruled, in essence, that a CLEC’s rate is

⁴⁰ *Id.* at ¶ 764.

⁴¹ *Id.* at ¶ 797.

⁴² CLEC Access Order I, ¶ 18. Industry commentators have also recognized that costs can legitimately vary from market to market. See Posner, *Natural Monopoly and its Regulation*, p. 32.

⁴³ ILEC Access Order, ¶ 45.

⁴⁴ Posner is highly critical of the distortions caused by improper cost averaging. “...there is a good deal of evidence that grossly inefficient pricing is widespread in the regulated industries. For example, a striking characteristic of the rate structures of regulated companies is the frequency with which the costs of providing different services or of providing the same service in different areas are averaged together and a single rate charged that appreciably exceeds the cost of serving some customers and is far below that of serving others. The charge for a long-distance telephone call of a given distance and duration is the same everywhere in the continental United States even though it is plain that differences of terrain and density make costs on different routes vary widely (often, I am informed by industry sources, by as much as 10 to 1)” Posner, *Natural Monopoly and its Regulation*, pp. 70-71. His concern is as much about the misallocation of resources caused by such internal subsidies as about the impact on competition. *Id.* at p. 73. “Internal subsidization is one seeming example of the perverse effects of regulation on pricing efficiency...” *Id.* at p. 75.

⁴⁵ Local Competition Order, ¶ 860.

not per se unreasonable merely because it exceeds the ILEC rate.”⁴⁶ And the underlying reason is the variance in the incumbent and CLEC network cost basis.

34. The Commission has also recognized that using deaveraged costs as the foundation for local service and access charges would be the best mechanism to encourage fair competition:

“...the Commission granted price cap carriers flexibility to deaverage SLC rates under certain conditions, concluding that such flexibility would ‘enhance the efficiency of the local telephone market by allowing prices to be tailored more easily and accurately to reflect costs and, therefore promotes competition in both urban and rural areas’”⁴⁷

35. The Commission’s conclusions are well founded. Costs are what they are. Actual costs have a stubborn truth to them, and reality does not go away simply because we wish to streamline or simplify regulatory policies. One part of that reality is that costs vary by geographic region, topography, and by population densities. Thus the Commission noted, “...many more parties oppose the use of such nationally-average cost data. These parties argue that nationally-averaged data ignore geographical divergent factors and the interests of small or rural LECs, do not account for variance of cost between incumbent LECs, and do not reflect the true cost of the service.”⁴⁸ Economists have also recognized this disparity of costs, especially in the RLEC setting,⁴⁹ as well as the severe market distortions that follow when actual costs are not used as a basis for rates, pricing and investment decisions.⁵⁰ Based on these decisions and the sound underlying economic analysis, PrairieWave and other RLECs proceeded with their small community developments on the eminently reasonable assumption that their access rates would be set based upon actual market costs, not artificially low incumbent rate caps, and stopped new market entry in 2001 after the CLEC Access Order I was issued.

Incumbent Access Rates Are Set By Regulation, Not By The Market

36. In light of the foregoing, this may be stating the obvious, but competitive markets do not set incumbent network access rates. Whether using price cap or rate-of-return analysis, all incumbent LEC network access rates are set by the Commission’s regulatory process based on some form of cost analysis, not based on market interactions. While RELCs like PrairieWave

⁴⁶ CLEC Access Order I, ¶ 37.

⁴⁷ ILEC Access Order, ¶ 37.

⁴⁸ Local Competition Order, ¶ 778.

⁴⁹ “...the costs of operating a local exchange in an urban area are less than those associated with operating a comparable service in a rural area where distances between the central office and users are greater and numbers of subscribers are fewer.” Wilson, *Deregulating Telecommunications* at p. 59. “Potential competition and fairness considerations may therefore call for tariffs being squarely based on cost.” Mitchell and Vogelsang, *Telecommunications Pricing, Theory and Practice*, p. 24.

⁵⁰ Sharkey, *The Theory of Natural Monopoly*, at p. 208.

engage in effective price competition with incumbents with respect to retail subscribers, no effective competition exists to set prices in the access environment. Further, incumbent networks were built under the protection of monopoly rate of return prices, allowing the incumbents to recover their costs at rates that were substantially higher than today's rates. To take these regulatory rates established using large study areas that average high and low cost markets out of their historical context and then assume that these rate are appropriate "market prices" for any specific market simply because the incumbent is a retail competitor of an RLEC is an economically erroneous analysis.

37. For all of these reasons, there are no market rates that can be used to set RLEC network access compensation and, except for the CLEC access decisions, the Commission has properly rejected market rates as an available mechanism for setting network access rates. One should not be surprised by this conclusion. The compensation problem is created by the regulatory interference in the market in the form of mandatory interconnection. While this is entirely appropriate, indeed even required, to establish competition in the telecommunications industry, it is required precisely because there is no market mechanism to establish competitive interconnection or the appropriate rates.

Negotiated Access Agreements

38. If actual access markets do not exist to set RLEC access rates, it is nevertheless possible to use market-like mechanisms to attempt to establish these rates. The use of bilateral negotiated agreements between RLECs and those using their networks is one example. However, negotiated agreements presume equal bargaining power,⁵¹ and as we have seen, when it comes to interconnection, the new market competitor has none.⁵²

39. The Commission has specifically rejected the reliance on individual negotiated agreements as a preferred method in setting just compensation due to unequal bargaining power. In the context of the section 251 interconnection rules, it noted that the existing RBOCs enjoyed unequal bargaining power, especially with smaller companies and new market entrants.⁵³ The Commission specifically found that

“... the requirements in section 251 obligate incumbent LECs to provide interconnection to competitors that seek to reduce the incumbent's subscribership and weaken the incumbent's dominant position in the market. Generally, the new entrant has little to offer the incumbent. Thus an incumbent LEC is likely to have scant, if any economic incentive to reach agreement.”⁵⁴

⁵¹ “The assumption that the ‘best’ or most efficient allocation of resources is achieved by free-market forces rests upon an assumption that there is a ‘proper’ allocation of bargaining power among the parties affected. Where the existing division of such bargaining power is ‘unequal,’ it may be thought that regulation is justified in order to achieve a better balance.” Breyer, *Regulation and Its Reform*, p. 32.

⁵² See text at ¶ 15 and accompanying notes, *supra*.

⁵³ Local Competition Order, ¶¶ 55, 141, 241, 245.

⁵⁴ *Id.* at ¶ 141.

40. In the context of CLEC access rates, it noted that some CLECs had used the tariff process to “...impose excessive access charges on IXC’s and their customers...” by setting “...access rates that were subject neither to negotiation nor to regulation designed to ensure their reasonableness. These CLECs have then relied on their tariff to demand payment from IXC’s for access services that the long distance carriers likely would have declined to purchase at the tariffed rate.”⁵⁵

41. At the same time, the Commission also noted that interconnecting “...carriers may have incentives to make unreasonable demands or otherwise fail to act in good faith”⁵⁶ and found that this is exactly what was occurring in the CLEC access area where IXC’s were arbitrarily changing CLEC access bills or simply refusing to pay.⁵⁷ Given these competing and often conflicting goals, the Commission concluded that voluntary agreements are not per se invalid, but that additional rules are necessary in order to encourage fair negotiations and arrangements.⁵⁸

42. The Commission acted wisely in arriving at these conclusions. Ubiquitous network sharing must be mandatory to promote competition. Voluntary negotiated agreements are not likely to have the desired result due to unequal bargaining power whether based on market power or regulatory artifice.⁵⁹ The crux of the matter thus becomes what rules should the Commission adopt to ensure that the rates, terms, and conditions for interconnection and network access are just, reasonable, and nondiscriminatory?

The Economic Basis for Network Access Rates Rule Making

43. The Commission was very aware of the problem of network interconnection compensation and undertook an extensive comment period and study of the best mechanisms for setting rates.⁶⁰ The Commission correctly noted that the costs and related pricing for interconnection, network access and universal service funding levels are all interrelated and should be based on a common unifying economic theory.⁶¹ Following this study of local exchange company costs and the underlying economic fundamentals, *the Commission concluded that the forward*

⁵⁵ CLEC Access Order I, ¶ 2.

⁵⁶ Local Competition Order, ¶ 141.

⁵⁷ CLEC Access Order I, ¶ 23.

⁵⁸ Local Competition Order, ¶ 56; CLEC Access Order I, ¶¶ 4, 40.

⁵⁹ Economists also agree that bargaining, while a form of market operations, is often unsuccessful due to transaction costs (especially with large numbers of parties), uniformity and fairness issues (especially where network economies are involved), and asymmetrical information costs. Breyer, *Regulation and Its Reform*, p. 24.

⁶⁰ See, for example, the Local Competition Order, Part VII, beginning at ¶ 618.

⁶¹ *Id.* at, ¶¶ 716, 718; CLEC Access Order I, ¶ 28.

*looking economic cost model is the best mechanism to use in determining interconnection and network access costs.*⁶²

The Forward-Looking Economic Cost Model

44. In its seminal Local Competition Order, the Commission stated:

“In the following sections, we first set forth generally, based on the current record, a cost-based pricing methodology based on forward-looking economic costs, which we conclude is the approach for setting prices that best furthers the goals of the 1996 Act. *In dynamic competitive markets, firms take action based not on embedded costs, but on the relationship between market-determined prices and forward-looking economic costs. If market prices exceed forward-looking economic costs, new competitors will enter the markets. If their forward-looking economic costs exceed market prices, new competitors will not enter the market and existing competitors may decide to leave. Prices ... must be based on cost under the law, and that should be read as requiring that prices be based on forward-looking economic costs.* New entrants should make their decisions whether to purchase unbundled elements or to build their own facilities based on the relative economic costs of these options. By contrast, because the cost of building an element is based on forward-looking economic costs, a new entrant’s investment decisions would be distorted if the price of unbundled elements were based on embedded costs. In arbitrations of interconnection arrangements, or in rulemakings the results of which will be applied in arbitrations, states must set prices for interconnection and unbundled network elements based on the forward-looking, long-run, incremental cost methodology...”⁶³ [Emphasis Added] “...[E]conomists generally agree that prices based on forward-looking long-run incremental costs (LRIC) give appropriate signals to producers and consumers and ensure efficient entry and utilization of the telecommunications infrastructure.”⁶⁴

45. In reviewing the comments of parties to its Notice of Proposed Rulemaking in the Local Competition Order,⁶⁵ the Commission further noted:

“Most new entrants and IXC’s agree that prices for interconnection and unbundled elements should be based on forward-looking, economic costs. Many state commissions also argue that, if federal pricing rules are adopted, forward-looking methodologies should serve as the basis for establishing rates

⁶² A theoretical conclusion supported by most economists. See Breyer, *Regulation and Its Reform*, p. 38.

⁶³ Local Competition Order, ¶ 620.

⁶⁴ *Id.* at ¶ 630.

⁶⁵ NPRM 96-182 released Apr 19, 1996.

in a competitive environment. ...Parties favoring a forward-looking, incremental cost methodology argue that it is the appropriate pricing standard for several reasons. First, such an approach stimulates the prices for network elements that would result if there were a competitive market for the provision of such elements to other carriers. In such a market, these parties argue, competition would drive prices to forward-looking costs, even if such costs were lower than a firm's historical costs. Second, unbundled element prices based on forward-looking economic costs prevent incumbent LECs from exploiting their market power at the expense of their competitors that are dependent on the incumbent LECs facilities. Third, forward-looking incremental cost methodology creates the right investment incentives for competitive facilities-based entry and creates incentives for the market to move towards competition while preserving opportunities for competition even if some network elements prove to be resistant to competition. Fourth, a pricing methodology based on forward-looking economic costs minimizes the incumbent LECs' opportunities to engage in anticompetitive cross-subsidization that could delay the emergence of effective competition. Finally, these parties argue that pricing based on forward-looking economic costs will lead to lower prices for consumers."⁶⁶

46. The Commission subsequently accepted these arguments, and adopted the forward-looking economic cost approach as the best model for encouraging effective and efficient competition.⁶⁷ It should also be noted that one of the states in which PrairieWave operates, Minnesota, has adopted the forward looking economic cost model as the appropriate mechanism for setting RLEC intrastate network access rates. South Dakota has stayed with the embedded historic cost approach, for the same practical reasons adopted by the Commission in its ILEC Access Order (that is, that the difference between existing embedded cost regulation and forward-looking economic costs is not material enough to force a change at this time).⁶⁸

47. It should be recognized that there are some potential practical problems with establishing forward looking economic costs and the degree to which the Commission may appropriately exercise its rate setting authority via the states.⁶⁹ Nevertheless *the general reasoning and*

⁶⁶ Local Competition Order, ¶ 635.

⁶⁷ *Id.* at ¶ 679.

⁶⁸ ILEC Access Order, ¶ 131. This is also illustrated by the very small variance between PrairieWave's proposed tariff rates based on its forward-looking economic costs and the NECA interstate rates based on historical costs. See Note 32 *supra* and the PrairieWave Petition at ¶ 6: "It is also significant that whether viewed from the NECA cost methodology or a FLEC methodology, the cost of providing access services in the rural areas served by PrairieWave is approximately the same."

⁶⁹ See *Verizon v. FCC*, 535 U.S. 467, 122 S. Ct. 1646, 152 L. Ed. 2d 701 (2002). The *Verizon* case is only the latest in a string of court decisions that question the application of the forward looking cost models in specific fact circumstances. See Breyer, *Regulation and Its Reform*, pp. 39-40. Economists have also recognized the problems of determining forward looking costs as opposed to historical embedded costs. See Posner, *Natural Monopoly and its Regulation*, p. 98; Breyer, *Regulation and Its Reform*, p. 38. However, these problems have mostly

economic conclusions reached by the Commission are compelling and support the use of company specific forward-looking economic costs for establishing interconnection and network access rates that are fair, just and reasonable. It should also be emphasized that while much of the Commission's analysis focuses on charges in excess of forward looking economic costs, *unfair competition and distortions in capital investment decisions also occur in situations where costs are arbitrarily set below long run forward-looking economic costs*, a concept that the Commission recognized as part of its analysis⁷⁰ and that is now causing very real problems for PrairieWave as it plans its future development and investment activities in a situation where network access revenues are so far below rates based on its actual forward-looking economic costs.⁷¹

The CLEC Access Orders

48. With this background, it is useful to stop for a moment to consider the Commission's CLEC Access Orders and the reasons underlying the decisions. While acknowledging and even specifically agreeing to all of the above, the Commission nevertheless proceeded to adopt benchmark rate caps tied to incumbent access rates. Unfortunately, in the RLEC markets, this decision has resulted in the very distortions and market inefficiencies that the Commission sought to avoid.

Cost Studies in a CLEC Access World

49. In the CLEC Access Order I, the Commission noted its success in using cost models in the ILEC access area:

“Incumbent LECs ... are closely regulated in their ratemaking to ensure that their interstate access charges are just and reasonable. In recent years, the Commission has repeatedly examined access rates, attempting to make them more economically rational. Some of the overarching goals the Commission has pursued in this effort include the promotion of competition, aligning access rate structures more closely with the manner in which costs are incurred, the removal of subsidies from access rates and deregulation as competition develops. The result of the Commission's efforts has been a steady reduction in access charges and in long distance rates which, in turn, has dramatically increased consumer usage of long distance service.”⁷²

“Historically, ILEC access charges have been the product of an extensive regulatory process by which an incumbent's costs are subject to detailed

surfaced in highly technical areas such as UNE element costing. PrairieWave did not find its forward-looking economic cost study to be overly burdensome or difficult for its RLEC markets.

⁷⁰ Local Competition Order, ¶ 620.

⁷¹ See the analysis of market distortion problems, beginning in ¶ 78, *infra*.

⁷² CLEC Access Order I, ¶ 8.

accounting requirements, divided into regulated and non-regulated portions, and separated between the interstate and intrastate jurisdictions. Once the regulated, interstate portion of an ILEC's costs is identified, our access charge rules specify in detail the rate structure under which an incumbent may recover those costs. This process has yielded presumptively just and reasonable access rates for ILECs.”⁷³

50. Nevertheless, the CLEC Access Order I declined to use the cost study approach so successfully employed in the ILEC area and instead decided to use incumbent access rates as surrogate benchmarks for CLEC access rates.⁷⁴ The CLEC Access Order I largely ignores the Commission's prior work, concluding that "...we lack an established framework for translating CLEC costs into access rates”⁷⁵ when, in fact, it did have the exact framework necessary to translate CLEC access costs into appropriate and fair rates—the forward-looking economic access cost model. What it did lack was the cooperation of the CLECs participating in the proceeding in providing the data necessary to make the forward-looking economic cost data available for Commission review.⁷⁶ Why did the Commission act without the relevant data?

51. First, the CLEC Access Order I expresses concern that some CLECs were using the filed tariff doctrine to impose access rates on IXC's that improperly shifted costs towards access revenue recovery. "...there can be little question that CLECs are adding dramatically to the overall level of access charges that IXC's are paying. We are concerned that the higher CLEC rates may shift an inappropriate share of the carriers' costs onto the IXC's and, through them, the long distance market in general.”⁷⁷

52. Second, and as a direct result of the first problem, the Commission was seeing a rapidly growing problem with CLEC tariffs and access rates. "Although the access charge debate previously has focused primarily on dominant carriers, as CLEC market share has increased, a correspondingly greater interest in the rates of competitive carriers has developed. As a result, CLEC access charges recently have been the subject of several Commission proceedings and

⁷³ *Id.* at ¶41.

⁷⁴ *Id.* at ¶ 4.

⁷⁵ *Id.* at ¶ 46.

⁷⁶ See the discussion beginning at ¶ 65 and accompanying notes, *infra*.

⁷⁷ CLEC Access Order I, ¶ 22. It is ironic to note that while the arbitrary CLEC behavior in large markets at the time of the Order in large part caused the Commission to act, the exact opposite is actually occurring in RLEC markets as a direct result of the CLEC Access Orders as access rates are forced substantially *below* actual costs. The only way to stop this seesawing back and forth based on disparate circumstances is by setting access rates based on company specific forward looking economic costs, whether accomplished by general rule making or through the waiver process.

the filings of several parties.”⁷⁸ Those proceeding were also indicating a large problem with these rates, given that CLECs were entirely unregulated at that time.⁷⁹

53. As a result, the Commission felt under great pressure to address the issue:

“Reacting to what they perceive as excessive rate levels, the major IXCs have begun to try to force CLECs to reduce their rates. The IXCs’ primary means of exerting pressure on CLEC access rates has been to refuse payment for the CLEC access services. ...We see these developments as problematic for a variety of reasons. We are concerned that the IXCs appear routinely to be flouting their obligations under the tariff system. Additionally, the IXCs’ attempt to bring pressure to bear on CLECs has resulted in litigation both before the Commission and in the courts. And finally, the uncertainty of litigation has created substantial financial uncertainty for parties on both sides of the dispute. This uncertainty, in turn, poses a significant threat to the continued development of local-service competition, and it may dampen CLEC innovation and the development of new product offerings.”⁸⁰

“Additionally, IXCs have threatened to stop delivering traffic to, or accepting it from, certain CLECs that they view as over-priced. ...These practices threaten to compromise the ubiquity and seamlessness of the nation’s telecommunications network and could result in consumer confusion. Once one or more IXCs refuse to do business with a CLEC, it will become impossible for that CLEC’s end users to reach, or receive calls from, some parties outside of the local calling area. If such refusals to exchange traffic were to become a routine bargaining tool, callers might never be assured that their calls would go through. We are particularly concerned with preventing such a degradation of the country’s telecommunications network. It is not difficult to foresee instances in which the failure of a call to go through would represent a serious problem, and, in certain circumstances, it could be life-threatening. Accordingly, the public interest demands a resolution to this set of problems.”⁸¹

54. The situation that caused the Commission to act in the CLEC Access Order I needed to be addressed. The Commission was correct to conclude under these circumstances that “...we are ...reluctant to permit CLECs to continue to tariff the access rates they charge IXCs *at the level they see fit, without any guidelines to ensure their reasonableness*.”⁸² [Emphasis added]

⁷⁸ CLEC Access Order I, ¶ 9.

⁷⁹ *Id.* at ¶¶ 11, 15-17, 20.

⁸⁰ *Id.* at ¶ 23.

⁸¹ CLEC Access Order I, ¶ 24. Note that this is another ramification of the ubiquitous nature of telecommunication networks and the value of mandatory interconnection.

⁸² *Id.* at ¶ 37.

However, nothing in the reasons cited by the Commission justify abandoning forward-looking economic cost analysis in favor of incumbent benchmark rates. In fact, the application of this analysis is exactly the right response, since the application of forward looking economic cost prevents the very abuse of arbitrary cost allocations that caused the disputes.

55. It was the Commission's own lapse in allowing CLECs to set their network access rates without any regulatory oversight that caused this problem.⁸³ Even the CLEC Access Order I recognizes the value of a properly determined access tariff filing: "...we recognize the attraction of a tariffed regime because it permits CLECs to file the terms on which they will provide service and to know that, absent some contrary, negotiated agreement, any IXC that receives access service is bound to pay the tariffed rates."⁸⁴ The issue, of course, is how to properly determine those rates. The application of tariffs based on forward-looking economic access costs is the best way to proceed, if only on a case-by-case basis. The CLEC Access Order I, unfortunately, takes a very different approach.

The CLEC Access Order Rationale

56. The CLEC Access Order I confusingly sets forth several reasons for moving to incumbent benchmark rates, none of which are persuasive in the face of an actual forward-looking economic cost study.

Network Access Competition

57. First, the Order relies on the assumption that the application of incumbent rates is appropriate on the theory that these rates represent market rates established in a competitive environment.

"...in setting the level of our benchmark, we seek, to the extent possible, to mimic the actions of a competitive marketplace, in which new entrants typically price their product at or below the level of the incumbent provider. We conclude that the benchmark rate, above which a CLEC may not tariff, should eventually be equivalent to the switched access rate of the incumbent provider operating in the CLEC's service area."⁸⁵

58. There is only one problem with this approach: *As demonstrated above,⁸⁶ there is no competitive access market between incumbents and CLECs that results in market set access*

⁸³ *Id.* at ¶ 37.

⁸⁴ *Id.* at ¶ 42.

⁸⁵ CLEC Access Order I, ¶ 42.

⁸⁶ *See* the discussion beginning at ¶ 19 *supra*.

*rates. Rather incumbent rates are set through cost-based regulation using cost averaging processes that are wholly inappropriate when applied to RLEC markets.*⁸⁷

59. The findings in the Order that indicate a lack of competition concerning network access are beyond question. It is interesting to note that the curious fact that none of the 349 competitive local service providers cited in the Order⁸⁸ continue in business today as solely access providers. Rather, they have been absorbed into service companies or diversified themselves into service companies. This is the direct result of the economic distortions introduced into the CLEC access rate process by the CLEC Access Order I. That is, by not applying the forward looking economic cost concept to CLEC access via the cost study process, the Order imposes unrealistically low incumbent access rates that distort the correct pricing signals that would otherwise occur in a freely competitive market established through a proper cost study process. The result has been curtailed RLEC development and the denial of competitive benefits to thousands of small community and rural consumers.

60. But the fundamental contradiction in the CLEC Access Order I is this: If the access market is not competitive, how can the Order conclude that incumbent rates are appropriate market based benchmarks? It cannot logically do so. The market no more determines incumbent access rates than it does CLEC access rates. There is no network access competition. That is the major reason why PrairieWave finds itself in the position it does today where its forward-looking economic access cost study indicates rates that are substantially greater than the benchmark incumbent rates.

Regulatory Burden

61. Second, the Order cites the burden and cost of regulatory oversight of the accounting and cost study process. "...we are especially reluctant to impose similar legacy regulation on new competitive carriers. We note that no CLEC has suggested that we adopt such a heavily regulatory approach to setting their access rates."⁸⁹

62. The assumption that preparing forward looking cost studies is too burdensome, complicated and costly is simply untrue and is being used as an excuse by many smaller CLECs on the mistaken belief that such studies would disadvantage them. This is arguing from ignorance, as very few CLECs have ever used the Part 32 accounting system or studied the relative advantages of doing so. If they did, they would recognize that Part 32 has built

⁸⁷ CLEC Access Order II also addresses this issue, but instead of providing further analysis, it repeats the CLEC Access Order I assertion that this was appropriate since it would "...mimic the actions of a competitive marketplace, in which new entrants typically price their product at or below the level of the incumbent provider." CLEC Access Order II, ¶ 29. What both Orders overlook in RLEC areas is that prices are set with respect to incumbent prices only for actual retail customers where the two compete, and that no effective competition exists between RLECs and incumbents with respect to network access and the related rates. See the text at ¶ 36 and the underlying analysis of the lack of a market for access competition beginning at ¶ 19.

⁸⁸ CLEC Access Order I, ¶ 116.

⁸⁹ CLEC Access Order I, ¶ 41.

into it regulatory relief in the form of what is known as “Class B” compliance status, which eliminates the need for systems as complicated as those imposed on the RBOCs and other large ILECs yet still provides the necessary data for access rate cost studies.⁹⁰

63. Part 32 is essentially a specialized cost accounting system tailored to telecommunications services. Its primary usefulness is the allocation of common costs (primarily labor costs) to specific activities unique to telecom as opposed to conventional expense accounts. As such, it really represents a form of activity based costing, a method of cost accounting that is now being widely deployed across numerous industries. Activity based costing is widely recognized as extremely effective for management information and decision making purposes.⁹¹ In fact, it is so useful that PrairieWave employs it not only for its ILEC and CLEC telephone operations, but for all of its unregulated unit operations as well (cable television, Internet access services, data services, construction and field repair services, etc.). It could fairly be said that the failure by CLECs to use the regulatory accounting process of Part 32 in order to allow the preparation of accurate cost studies is simple management negligence, especially in the RLEC industry.⁹²

64. The complications arise not from Part 32 cost accounting, but from the jurisdictional and other separation processes under Parts 36 and 69 necessary to complete an access rate cost study.⁹³ Fortunately there are a number of firms (both accounting and consulting firms) that are available at very reasonable cost to perform these studies. In fact, these firms actively compete for small ILEC and RLEC business, bringing real competitive market pricing to at least this part of the industry.

65. It is out of sheer accounting ignorance that no CLEC in the CLEC Access Order I proceedings suggested adopting the ILEC regulatory approach, with the result that the Commission was deprived of the very information that would have properly resolved the problem. In fact, the CLEC Access Orders are notable primarily for their complete lack of CLEC access cost study analysis, even though the Commission has heavily focused on the appropriateness of such studies in setting proper rates for similarly situated small ILECs.⁹⁴

⁹⁰ 47 C.F.R. § 32.11. It is worth noting that substantial technical reference materials, seminars and training courses, and practical assistance is available to small RLECs through the National Exchange Carriers Association.

⁹¹ See, generally, Charles T. Horngren, George Foster and Spikant M. Datar, *Cost Accounting, A Managerial Emphasis* (Prentice-Hall, Inc. 1994) at pp. 115, 159, and 199; Maurice L. Hirsch, Jr., *Advanced Management Accounting* (South-Western Publishing Co. 1994) at pp. 74-83; and Robin Cooper and Robert S. Kaplan, *The Design of Cost Management Systems* (Prentice-Hall, Inc. 1991) at pp. 257, and 267-461. Cooper and Kaplan devote an entire chapter to the use of activity based cost systems in service organizations. *Id.* at Chapter 7, pp. 466-575.

⁹² Actually, there might be cases where the use of Part 32 accounting is not possible, though these should be extremely rare. For this reason, the use of the Commission’s waiver process might be the best way to address the issue, since it allows RLECs to voluntarily choose to use the appropriate Part 32 accounting rules, prepare the necessary cost studies, and present the data to the Commission to support a specific waiver.

⁹³ See 47 C.F.R. Parts 36 and 69.

⁹⁴ Much, I am sure, to the immense frustration of the Commission and its staff. This situation had not improved by the time of the CLEC Access Order II. CLEC Access Order II, ¶¶ 35, 45. In fact, PrairieWave believes it is

66. The CLEC Access Order I's conclusion that the incumbent benchmark is justified by "... the extreme difficulty of establishing a 'reasonable' CLEC access rate given the historical lack of regulation on the process of CLEC ratemaking"⁹⁵ is not supported by the record or, rather, is a conclusion that results from the notable lack of industry cooperation rather than any inherent difficulty in preparing the data.⁹⁶ The preparation of a forward-looking economic access cost study is neither difficult nor expensive, and PrairieWave's filing is self evident on this point.⁹⁷ Further, such a study does not depend in any way on a prior lack of regulation *per se*. It is based on *forward-looking* economic costs, not historical regulation.

The Rate Averaging Doctrine

67. Third, the Order cites the potential adverse impact of divergent network access rates on the IXC's obligation to set national average rates.

"We are concerned that, in this environment, permitting CLECs to tariff ***any rate that they choose*** may allow some CLECs inappropriately to shift onto the long distance market in general a substantial portion of the CLECs' start-up and network build-out costs."⁹⁸ [Emphasis Added] "... there is ample evidence that the combination of the market's failure to constrain CLEC access rates, our geographic rate averaging rules for IXCs, the absence of effective limits on CLEC rates and the tariff system create an arbitrage opportunity for CLECs to charge unreasonable access rates."⁹⁹

68. Note that this concern is only a problem if the costs included in the determination of access rates are, in fact, arbitrary or otherwise improper. The use of the forward-looking economic cost study process prevents this result, and in a way that fosters the efficient allocation of capital and encourages local competition.

the first CLEC, let alone RLEC, to present a full forward-looking economic cost study to the Commission for its consideration.

⁹⁵ CLEC Access Order I, ¶ 44(4).

⁹⁶ It is also possible that the timing of the Commission's initial CLEC decision, though required by the obvious abuses by a few early metropolitan area CLECs, made the development of complete costs studies impractical because the CLEC networks had not been established long enough to gather and audit the data. It has taken PrairieWave two years to complete a full year of audited data and related cost studies since it acquired the Dakota operations, though the mechanics of the underlying Part 32 accounting system and the cost study process itself are relatively straightforward and well understood by the company.

⁹⁷ The Commission has made short work of similar complaints by small CLECs involving their alleged inability to change their billing systems to handle access billing complexities. *See, for example*, the Commission's resolution of the Z-Tel waiver request in CLEC Access Order II, ¶ 63. If the Commission would take similar steps in the CLEC access rate cost study area, it could make short work of the RLEC market distortions.

⁹⁸ CLEC Access Order I, ¶ 33.

⁹⁹ *Id.* at ¶ 34.

69. The fundamental issue underlying this concern is the long distance consumer rate averaging doctrine. Long distance rate averaging as a favorable consumer concept designed to ensure uniform pricing and service availability has long been a Commission goal.¹⁰⁰ The Commission explained the rate averaging concepts in the ILEC Access Order:

“In section 254(g) of the Act, Congress codified the Commission’s pre-existing geographic rate averaging and rate integration policies. The Commission implemented section 254(g) by adopting two requirements. First, providers of interexchange telecommunications services are required to charge rates in rural and high-cost areas that are no higher than the rates they charge in urban areas. This is known as the geographic rate averaging rule. Second, providers of interexchange telecommunications services are required to charge rates in each state that are no higher than in any other state. This is known as the rate integration rule. In the *Geographic Rate Averaging Order*, the Commission explained that geographic rate averaging benefits rural areas by providing a nationwide telecommunications network whose rates do not reflect “the disproportionate burdens that may be associated with common line recovery costs” in rural areas. The Commission also noted that geographic rate averaging ensures that rural customers will share in lower prices resulting from nationwide interexchange competition.”¹⁰¹

70. Notice that it is precisely because of the access rate differences in small communities and rural areas that the Commission adopted the long distance rate averaging rules. It is completely inconsistent with this rationale to now use the implications of RLEC access cost variances to impose rate averaging on the local and regional owners and operators of the network, especially in an RLEC situation. RLECs do not have national customer bases and therefore they do not have the ability to average costs, especially those who operate only in higher cost rural communities. The Commission recognized this very problem in the CLEC Access Order:

“Our rules require such [large] ILECs to geographically average their access rates. This regulatory requirement causes these ‘non-rural ILECs’ effectively to use their low-cost, urban and suburban operations to subsidize their higher cost, rural operations, with the effect that their state-wide averaged access rates recover only a portion of the ILEC’s regulated costs for providing access service to the rural portions of its study area.”¹⁰²

¹⁰⁰ “Under section 254(g) of the Act, interexchange carriers bear the cost of averaging on a nationwide basis the different per-minute switched access rates charged by LECs.” ILEC Access Order, ¶ 64. This is properly so, since it is the IXC carriers that have the national subscriber base necessary to average these costs across the entire country.

¹⁰¹ *Id.* at ¶ 179.

¹⁰² CLEC Access Order I, ¶ 64.

71. Averaging is possible only when the companies in question operate on a national scale and can therefore average the costs across a truly national subscriber base. This is precisely why cost averaging has historically been imposed on IXC's via cost-based access rates under section 254(g) and USF contributions (and why it should now be imposed on their fast emerging competitive cousins, the national cellular carriers and now the VoIP companies).¹⁰³ In its consideration of rural access rates for small rate of return carriers, the Commission specifically addressed this issue and declined to ease the averaging burden imposed on IXC's by forcing below cost access rates on the ILEC's:

“While we recognize that rate disparities may create pressure on interexchange carriers to deaverage long distance toll rates, contrary to the requirements of section 254(g), ***we reject the proposition that we should address this problem by prescribing below-cost rates.*** Rate disparities are due partly to rate structure differences that we address in this Order, and partly to actual cost differences between price cap and rate-of-return carriers, as well as among rate-of-return carriers themselves.”¹⁰⁴ [Emphasis added.]

72. This is consistent with the historical development of cost averaging, where averaging via long distance rates was specifically preferred to passing through the entire cost of the local connection to the local service user, a decision that was based squarely on fairness situations in rural areas.¹⁰⁵ What is happening today can be likened to the swinging of a pendulum, this time resulting in a over allocation of network costs to local subscribers as opposed to long distance users, at least in the RLEC areas.

73. The rural ILEC analysis is precisely the analysis that should be applied in the case of RLEC's, and for very good reasons as will be discussed in detail below. Averaging as applied to geographically isolated RLEC's has the effect of setting access rates below costs and therefore sending precisely the wrong price and investment signals to the RLEC and discourages new competitive investment. This is exactly the opposite of what the Commission intended to accomplish and is directly attributable to the CLEC Access Order I's bypassing the forward-looking economic cost model. This problem is especially acute in the small communities and rural areas of the country. Traditionally, the RBOC's and the other larger telephone companies ignored these areas precisely because of the high investment and service costs. This led to the creation of the independent local exchange carriers and, today, to the establishment of local and regional facilities based CLEC's (more frequently than not offshoots of independent LEC's). These companies understand the unique needs of the smaller communities and are willing to incur the costs of bringing advanced services to these areas, but only on the assumption that their development costs can be recovered through appropriate region adjusted network access costs and, in the extremely rural areas, Universal Service Funding.

¹⁰³ See, also, the reference to the section 254(g) IXC rate averaging requirement in the CLEC Access Order I, ¶ 31.

¹⁰⁴ ILEC Access Order, ¶ 88.

¹⁰⁵ Friedlander, *Natural Monopoly and Universal Service*, pp. 37-38.

Regulatory Simplification

74. Finally, in several places the CLEC Access Order I cites the administrative simplification afforded by a “bright line” standard. “It now appears that the best means of proceeding is to restructure and partially deregulate the environment in which CLECs provide access service, providing a bright-line rule that will facilitate effective enforcement.”¹⁰⁶ “...a benchmark provides a bright line rule that permits a simple determination of whether a CLEC’s access rates are just and reasonable. Such a bright line approach is particularly desirable given the current legal and practical difficulties involved with comparing CLEC rates to any objective standard of ‘reasonableness.’”¹⁰⁷

75. The Commission took an even more strident approach in CLEC Access Order II:

“Both of TDS’s requests assume incorrectly that the Commission adopted a cost-based approach to competitive LEC access charges in its *CLEC Access Reform Order* [what we are calling CLEC Access Order I]. The Commission explicitly declined to apply this sort of regulation to competitive LECs and explained that it was applying a market-based approach. Consistent with this finding, the Commission held that it will assess the reasonableness of competitive LEC access rates by evaluating market factors rather than a particular carrier’s costs. The requests by TDS would involve an examination of carrier costs rather than market data to determine competitive LEC access rates. Because such an examination would be contrary to the Commission’s market-based approach to competitive LEC access charge, we must reject TDS’s requests.”¹⁰⁸

76. While perhaps appropriate with respect to TDS and its larger markets, this is clearly a mistaken application of the Commission’s priorities when applied to RLEC markets. As noted above, the Commission has previously balanced the benefit of simplification with the problems created by cost averaging and concluded that the power of forward looking economic costs to send the appropriate investment and development signals far outweighs the goal of administrative simplification.¹⁰⁹ PrairieWave certainly agrees with this assessment and believes that its own forward-looking cost study vividly highlights this issue. The only “practical difficulties” that faced the Commission in the CLEC Access Order I was the lack of

¹⁰⁶ CLEC Access Order I, ¶ 25.

¹⁰⁷ *Id.* at ¶ 41.

¹⁰⁸ CLEC Access Order II, ¶57.

¹⁰⁹ See the discussion beginning at ¶ 43 *supra*. The conflict between effective regulatory action and simplification is neither unusual nor limited to this situation. The priority decision is almost always present, and every decision to intervene is in some sense a compromise of the goal of administrative simplicity. See Breyer, *Regulation and Its Reform*, p. 38. The question in this discussion is whether to adopt simplicity in light of the serious market distortions that are resulting in the RLEC markets in general, and PrairieWave’s markets in particular. This would plainly seem to be a major mistake.

available forward-looking economic cost data,¹¹⁰ and that data is now provided in PrairieWave's filing, at least with respect to PrairieWave's markets. It is interesting to note that some states, including Minnesota, have adopted the use of forward looking economic costs in setting access rates in spite of the "burden." Administrative costs are simply not that material, especially when viewed against the serious market distortions that proceeding without proper costs studies is causing.¹¹¹

77. With a focus on deregulation for the sake of retail market entry and competition, it is only natural to try to think of ways to minimize regulation of access rates. But as discussed above, the network access rate issue is itself an artificiality created by regulatory intervention to force mandatory network interconnection. It is a regulatory taking and cannot be resolved fairly except through rate setting mechanisms that relate closely to company specific actual market costs.¹¹² Administrative simplicity should not trump forward looking economic cost evaluations where the disparity between actual RLEC costs and administratively convenient incumbent rate caps is so wide, especially given the economic distortions taking place in the RLEC marketplace as a direct result of this disparity, as we shall now examine.

Additional Problems Caused by Incumbent Rate Benchmarking

78. Using incumbent rates as RLEC rate caps causes further disadvantages and market distortions that far outweigh the claimed advantages. The unfair impact of the national benchmark access rates is dramatically highlighted by the discrepancy between these mandated rates and the rates supported by PrairieWave's own forward looking economic cost study. This kind of discrepancy has created numerous problems for RLECs like PrairieWave that are unfortunately having the effect of directly undermining the Commission's original goals for the rate setting process outlined above.

¹¹⁰ This is particularly true of the TDS request, which was long on rhetoric and short on hard data. See CLEC Access Order II, ¶ 58. One can well appreciate the Staff's frustrations, which is likely the reason for the language in ¶ 57. However, it seems that in the RLEC markets at any rate, and especially in PrairieWave's specific markets, the "market-based approach" and an evaluation of "market factors" clearly do not result in fair or just access rates nor do they support the Commission's stated goals. In these circumstances, a cost based approach is the only fair and just approach, which is the underlying theme of this entire paper. It should also be noted that the Commission's regulatory decisions, themselves, operate as powerful "market factors" and can radically change the complexion and characteristics of a market. See Mitchell and Vogelsang, *Telecommunications Pricing, Theory and Practice*, p. 265. This observation, of course, makes the Commission's reliance on "market factors" in the CLEC Access Orders at best incomplete and at worst circular and illogical. One would therefore not be surprised to see the implementation of these decisions result in unintended market distortions, which is exactly what is occurring in the RLEC markets.

¹¹¹ See discussion beginning at ¶ 78 *infra*.

¹¹² "The existence of joint costs...and regulation makes it impossible to answer the competition/regulatory question by simply analyzing market structure." Breyer, *Regulation and Its Reform*, p. 287.

Limitations on Cost Recovery Shifting

79. What will happen if RLECs are not allowed to set network access rates based upon deaveraged, company specific forward-looking economic costs? The answer lies in a return to the Commission's opening observations about the interrelationships between interconnection costs, network access costs and local rates. As noted by party comments: "...retail local service rates...have been developed with the assumptions that incumbent LECs will receive access charge revenues."¹¹³ To which should be added, "...as well as Universal Service Funding, where appropriate." This same reasoning applies to the facilities based RLEC. Local rates will have to rise, as the Commission tacitly acknowledges in its rulings allowing for increases in Subscriber Line Charges ("SLC") to compensate for other reduced revenues.¹¹⁴

80. This is where the CLEC Access Orders assumptions flatly clash with the reality of RLEC operations. The mechanism of transferring network costs, even forward-looking economic costs, to local rates is not available to RLECs in competitive markets because local rate or SLC increases are not possible due to incumbent pricing competition. Like access rates, the large incumbent LECs are able to average lower and higher cost areas to recover costs from their local rates and Subscriber Line Charges. The competitive RLECs like PrairieWave are therefore not free to pass all of the reduced access revenue through to end-users. RLECs are simply forced to absorb the costs, which lowers economic returns, discourages new investment and ultimately undercuts their competitive position.

81. The CLEC Access Orders unrealistically takes the position that a RLEC should be able to justify additional local service charges.

"...adopting a benchmark for tariffed rates allows CLECs the flexibility to obtain additional revenues from alternative sources. They may obtain higher rates through negotiation. If a particular CLEC provides a superior quality of access service, or if it has a particularly desirable subscriber base, one or more IXC's may be willing to pay rates above the benchmark in order to receive that CLEC's switched access service. Similarly, CLECs retain the flexibility to charge their end users higher rates for the access service to which they subscribe. Here again, if the CLEC provides a superior product, the end user likely will be willing to pay for it."¹¹⁵

¹¹³ Local Competition Order, ¶ 979. This was certainly PrairieWave's assumption when it began its build outs in 1997 and since the Commission issued CLEC Access Order I in 2001, PrairieWave has been unable to financially justify entry into new rural markets. See Note 122 *infra*.

¹¹⁴ *Id.* at ¶ 984. See, also, this interplay described in the CLEC Access Order I, ¶¶ 28, 31.

¹¹⁵ CLEC Access Order I, ¶ 43. A similar analysis is repeated in CLEC Access Order II at ¶ 58. But, again, it is based on an incomplete record in that no evidence or argument was presented that such cost recovery shifting was not possible.

82. While this may be true in certain limited circumstances where the CLEC competes in large metropolitan areas, it is pure speculation when applied to RLEC markets and unsupported by anything in the record. In fact, such a scenario has not materialized. It cannot materialize because under the CLEC Access Order I, network access has become a uniformly priced commodity service with no distinguishing features that allow pricing variances. Worse, it is a direct contradiction of Order's prior findings that the access market is not competitive. In fact, one of the reasons that the competitive access market has disappeared is the commodity nature of the service. There is no "higher quality of access" and therefore no economic basis to negotiate higher access rates. The imposition of incumbent rate caps as the default access charge option effectively undercuts any ability a RLEC might have to negotiate more fair rates. The rules create the very unequal bargaining power that the Commission sought to avoid. PrairieWave has found itself in precisely this situation in its negotiations with Qwest, MCI, Sprint and other large IXC's as well as with the numerous cellular carriers operating in its small community markets. Its only effective recourse at this point is through this filing with the Commission.

83. While this is not the time or place to fully analyze the complete revenue recovery mechanisms available to RLECs and the limitations that current regulation impose,¹¹⁶ several additional points should be noted:

1. The general forward-looking economic access cost theory and the specific study submitted by PrairieWave do not contain the Common Carrier Line ("CCL") charge that in the past represented the access cost recovery element for fixed local costs. What we are examining here is the problem of recovery of market specific switching and other variable costs that are simply higher in rural RLEC markets due to the demographic and topological factors discussed above. This makes the use of cost-averaged incumbent access rates as RLEC price caps inappropriate. It also makes the assumption that some or all of these costs can be recovered from end-users theoretically unsound. It should therefore be no surprise that PrairieWave has also found it impossible in practice, at least in its RLEC markets.
2. It is highly questionable that the incorporation of at least some form of CCL cost recovery really involves the subsidy of local services by long distance access rates claimed by the IXC's and cellular companies.¹¹⁷ This, of course, reflects the long running historical debate of what costs of local service are appropriate to allocate to

¹¹⁶ This time is fast approaching as the Commission prepares to consider the numerous proposed intercarrier access plans and their interrelationship to local service fees and Universal Service Fund compensation.

¹¹⁷ "Although [the policy of federal and state regulators to support revenue transfers from long-distance to local telephone service] has been widely referred to as the local-service subsidy, the rate structure may nevertheless have been subsidy free. Trunk-call rates were substantially higher than marginal costs, but they not have exceeded the stand-alone costs of long-distance service." Mitchell and Vogelsang, *Telecommunications Pricing, Theory and Practice*, p.252, fn. 1.

long distance service, since it is unquestioned that the local loop is a necessary network element for long distance service as well as local calling services.¹¹⁸

3. Because of the economics of rural telecommunications network construction, RLECs generally have not built out to the extremely remote areas and therefore are unable to qualify for Eligible Telecommunications Carrier (“ETC”) status. As a result, RLECs are not able to participate in the Universal Service Fund subsidies, which have been explicitly adjusted up for rural rate-of-return ILECs to compensate for other access rate changes.¹¹⁹ That is, RLECs cannot shift a portion of their forward-looking economic access costs recovery to the USF fund or similar subsidy pool.¹²⁰

84. As a result of the interaction of these competitive and regulatory restrictions and contrary to the assumptions in the CLEC Access Orders, RLECs are not able to shift the recovery of their forward-looking economic access costs to other revenue sources.¹²¹ The result is that RLEC construction has all but ground to a halt. PrairieWave, for example, has not entered a new community market since the adoption of the incumbent access rate price caps in 2001, primarily due to lack of available funding given current revenue streams.¹²² Further, it is

¹¹⁸ Breyer makes the historically interesting point that prior to the Communications Act of 1934, “...commissions took the approach that was easier to administer. They assumed that telephones, local loops, and local exchanges were all installed to provide local service. They allocated these costs to local service and sought to recover all of them through local rates.” Breyer, *Regulation and Its Reform*, p.296. This was later abandoned in favor of cost allocations as the Commission, now in existence, recognized that both long distance and local service depended on these same elements. *Id.* at pp. 291, 296-297. In this sense, the Commission’s recent CLEC access rate decisions represent yet another swing in the pendulum back to burdening the local service subscriber, a subject, I am sure, to be revisited again in the forthcoming intercarrier compensation debates. Breyer outlines a compelling argument based on the value of network externalities that suggests that the further shift to local service fees is economically and socially unsound. *Id.* at p.295. He also makes the interesting observation that we should learn from our past mistakes: “...lessons from ...experience may be particularly useful as legislators seek to change existing systems and as administrators of new programs seek to avoid past mistakes,” though he leaves it up to his readers to draw the line between the dots in telecom. *Id.* at Preface remarks.

¹¹⁹ See ILEC Access Order at ¶ 128.

¹²⁰ This is a fortunate result given the financial instability of the USF pools. In any event, it is not economically efficient to use the USF pools to subsidize market specific direct forward-looking access costs.

¹²¹ We are discussing here only the situation in RLEC markets. It is possible (indeed, in light of the very different service costs, very likely) that these distortions do not exist to the same degree in larger metropolitan markets and especially in situations where CLECs use incumbent UNE elements or resale rates to offer services. Again, this makes the waiver procedure a potentially acceptable regulatory alternative rather than attempting to expand an arbitrary exemption like the Rural Exception.

¹²² PrairieWave management has prepared several new market entry studies, all of which have been rejected by its board of directors, its shareholders, and its banks. The primary reason is that the potential rates of return, which are heavily influenced by potential access revenues, do not justify the additional risks, particularly the regulatory risks surrounding network access revenues. As a practical matter, PrairieWave has made its waiver request in large part because of these objections and in order to establish the proper access revenue rules for its RLEC operations so that it can proceed with its planning and investment decisions. This is a very real world example of improper pricing signals resulting in inefficient capital allocation and investment decisions assuming, of course, that the waiver is granted. Without the waiver, the existing imposition of incumbent rate caps coupled with PrairieWave’s inability to shift its cost recovery to other services makes further RLEC development uneconomical.

unlikely that PrairieWave would have expanded at all if it had known that its market specific access costs would be ignored in favor of arbitrary averaged incumbent access rates that are unrelated to (and far below) the costs in its markets.¹²³

Cross-Subsidization of Incumbent and Competitor Operations

85. Unfairly low access rates based on incumbent benchmark rates instead of actual costs effectively subsidize the RLEC competitors' access to its network, allowing the competitors to charge less for their local and long distance services.¹²⁴ This is a serious economic distortion of not only the competitive playing field, but also in the allocation of continued investment capital. RLEC competitors use the subsidy provided by non-cost based low access rates to fund their own continued technology upgrades or to preserve their monopoly market shares through lower service rates. This has magnified the effect of stopping further development commitments by RLECs as the true impact of this competitive subsidy to the incumbent monopoly became apparent.¹²⁵ Not only is this result anti-competitive, it actually creates a new barrier to entrance into new incumbent dominated markets and results in the very distortion of capital investment efficiency decisions sought by the Commission in adopting its rules.¹²⁶ And in the ultimate perverse irony, it operates to the very benefit of the monopoly incumbents that were the target of the Act to begin with.

86. The Commission has recognized this very problem in its analysis of small, rural rate of return LECs and found that using actual costs, instead of averaged costs (such as the averaging implicit in the use of incumbent access rates) reduced the cross-subsidization problem:

and therefore not financable. *The Commission needs to understand that each dollar of interstate access revenue that is lost comes directly out of the company's net operating cash flow. The incumbent proxy caps in PrairieWave's markets and PrairieWave's actual costs are so disparate that this results in a reduction of cash flow of about 20% per year. That is a substantial difference in evaluating overall rates of return and by itself would likely change the company's investment decisions and result in continued expansion into new RLEC markets.* Breyer specifically acknowledges that industry regulators should be very sensitive to private industry rates of return and the impact that regulation might have on the ability to raise capital. Breyer, *Regulation and Its Reform*, p. 19.

¹²³ See ¶ 35 *supra* for an analysis of the reasonableness of this assumption given the Commission's early decisions. See, also, Note 32 *supra* for a discussion of the rate disparities that result from not applying actual costs.

¹²⁴ Breyer has analyzed this very problem of cross subsidization inherent any time pricing is set below long run costs. Breyer, *Regulation and Its Reform* at p.307.

¹²⁵ PrairieWave is not the only small CLEC to raise this problem of frustrated expectations, though it is the only one to actually prepare a cost study proving the point. See CLEC Access Order II, ftn. 78 and ¶ 23.

¹²⁶ Posner, for one, has recognized the barrier to entry that unfair cost averaging which allows pricing below costs provides incumbent monopolists. See Posner, *Natural Monopoly and its Regulation*, pp. 20, 85, 90. It is the obvious extension of the problem with distorting price signals that lead to inefficient capital allocation and incorrect investment decisions.

“We conclude that granting rate-of-return carriers more flexibility to deaverage SLC rates will ‘enhance the efficiency of the local telephone market by allowing prices to be tailored more easily and accurately to reflect costs and, therefore promotes competition in both urban and rural areas.’ *Deaveraging has the added virtue of reducing implicit subsidies created by averaged rates.*”¹²⁷ [Emphasis added]

Disparate Competitive Pricing Power

87. Shifting revenue recovery to local rates or SLC charges is blocked by another asymmetry created by the CLEC access rules. The use of incumbent rates as price caps allows the larger incumbent to using its ability to average out its operating costs over a larger subscriber base often concentrated in denser, and therefore lower cost, areas. This puts the RLEC at a competitive cost disadvantage that is directly reflected in its local service rates. As discussed above, the Commission acknowledged this problem in the CLEC Access Order I.¹²⁸ The Commission also recognized the unique problems of competition against larger LECs in the ILEC Access Order:

“High per-minute charges may place [rate of return small ILECs] at a disadvantage in competing with new market entrants, including neighboring price cap carriers. In addition, higher rates and implicit subsidies may discourage efficient local and long distance competition in rural areas and limit consumer choice.”¹²⁹

88. This is exactly PrairieWave’s situation where it competes against Qwest and Frontier, both of which can average costs over much larger customer bases in large, metropolitan areas. It is in precisely these circumstances where the Commission has recognized that CLEC access costs could permissibly be higher than the incumbent, and rightly so.

CLEC/ILEC Rate Differentials

89. The CLEC Access Order I puzzles over why some CLECs charge higher access rates than others or than the incumbents in the same market. Because the Order chooses to side-step the underlying network cost differences supported by the forward-looking economic cost theory, the Order improperly concludes that the higher rates have resulted in inefficient market entry:

“...the historical ability of CLECs to tariff access rates well above the prevailing ILEC rate may have contributed to economically inefficient market entry by certain CLECs. We intend the declining benchmark scheme to wean competitive carriers off of their dependence on tarified, supra-ILEC access rates

¹²⁷ ILEC Access Order, ¶ 58.

¹²⁸ See ¶ 24 *supra*.

¹²⁹ ILEC Access Order, ¶ 6.

without the disruption of a flash-cut to the prevailing market rate. We therefore think it important to ensure that this transitional mechanism serves that purpose, rather than presenting CLECs with the opportunity to enter additional markets in a potentially inefficient manner through reliance on tariffed access rates above those of the competing ILEC.”¹³⁰

90. This is perhaps the most confusing statement in the entire Order. It completely ignores the possibility that underlying economic costs could (and in fact do) explain the rate difference in RLEC markets. It ignores the lack of competition in the access market (indeed, the complete lack of such a market) that makes the Order’s reliance on incumbent rates theoretically flawed. It also ignores the issues that make incumbent and CLEC access cost structures and rates “apples and oranges.” It is simply not true in RLEC markets. It is the imposition of incumbent access rates as rate caps that is distorting the market and creating economically inefficient results including, among other things, in the form of a lack of competitive market entry because the incumbent rates are so much lower than actual forward-looking economic costs—***the very problem highlighted by the Commission in its original analysis of forward-looking economic costs in the Local Competition Order.***

“...rates must be allowed to change to reflect actual cost...rather than systemwide average costs. ***If prices are not allowed to adjust, then the entry that does occur is inefficient and ultimately destabilizing.***”¹³¹ [Emphasis added]

91. Ironically, the Commission has recognized this very problem of improper market entry signals in rural areas where network access rates do not take into consideration market specific costs:

“Reallocating costs rather than prescribing a single rate also will foster the development of efficient competition in the exchange access market. Rates that reflect an individual carrier’s cost of service provide the proper signals to permit a potential entrant to decide whether to enter a particular market. ...if a target rate were set too low, a barrier to competitive entry would be created.”¹³²

92. Commentators have also recognized the danger of improper market entry and cost signals that result from regulatory policies that work to “...eliminate profits lopsidedly and thereby create improper price signals.”¹³³ It is certainly not unfair to characterize the difference between incumbent access rate caps and PrairieWave’s actual network costs as decidedly “lopsided.” So much so that without considering the very real cost differences of

¹³⁰ CLEC Access Order I, ¶ 58.

¹³¹ Sharkey, *The Theory of Natural Monopoly*, at p. 208.

¹³² ILEC Access Order, ¶ 84.

¹³³ Posner, *Natural Monopoly and its Regulation*, p. 16.

PrairieWave's operations, the Order in effect operates as an economic taking of the RLECs property without just compensation.

93. What has happened in PrairieWave's markets is that new technologies and decreasing technology costs have made it economically possible, even desirable, to overbuild small communities and provide advanced voice, video and data services.¹³⁴ This is not a case of inefficient market entry, where new competition results in an increase in overall total costs of serving the market.¹³⁵ Rather this is a case of where high fixed costs of market entry are rapidly decreasing, allowing even small markets to support competition by more than one firm.¹³⁶ And it is worth noting the additional benefits that PrairieWave and other RLECs play in pushing the rapid diffusion of new technologies out to the rural areas.¹³⁷

94. However, the regulatory result is distorting what would otherwise be a favorable market entry signal because it violates the assumption made by PrairieWave (and also by other RLECs) that network access rates and revenues would be fair and reasonable, based on its specific rural market cost structure.¹³⁸ This is precisely the conclusion reached by the Commission with respect to small community rate-of-return ILECs.¹³⁹

¹³⁴ "...an interdependence between technology and scale exists. Generally speaking, the major advances in transmission technology have brought forth systems of larger capacity and lower average cost at full capacity." Sharkey, *The Theory of Natural Monopoly*, at p. 191.

¹³⁵ See Sharkey, *The Theory of Natural Monopoly*, at p. 9.

¹³⁶ *Id.* at pp. 19-20; Mitchell and Vogelsang, *Telecommunications Pricing, Theory and Practice*, p. 253; and Breyer, *Regulation and Its Reform*, pp. 287 293, 313. See, also, Posner, *Natural Monopoly and its Regulation*, p. 48. Posner has specifically recognized the role technological change is playing in opening up the possibilities for competition in telecommunications: "Communications is a contemporary example of an industry undergoing rapid technological changes that are apparently opening up a host of new competitive opportunities." *Id.* at p. 106. He was almost prescient in his forecast of what would shortly occur in the RLEC markets as a result of the 96 Act. See, also, the analysis of Mitchell and Vogelsang, which suggests that the technological diversity of the modern telecommunications networks allows different competitors to exploit different economics of scale at different volume levels. Mitchell and Vogelsang, *Telecommunications Pricing, Theory and Practice*, p. 10. This is precisely what PrairieWave is doing with its proprietary network designs.

¹³⁷ For a summary of technological innovation and the benefits of more rapid diffusion through competition, see Posner, *Natural Monopoly and its Regulation*, p. 43.

¹³⁸ See ¶ 84 and accompanying notes *supra*.

¹³⁹ "...rate-of-return carriers ... will retain the flexibility to establish rates based on their own costs in the areas they serve, rather than being forced to conform to a prescribed target rate." ILEC Access Order, ¶ 12. In general, PrairieWave believes that it is far more analytically fair to RLECs to be compared to small rate of return ILECs than large CLECs. "...the Commission consistently has taken into consideration the differences between price cap and rate-of-return carriers, as well as the specific challenges faced by small local telephone companies serving rural and high-cost areas." *Id.* at ¶ 134.

Access Rate Arbitrage and “Gaming the System”

95. The CLEC Access Order I concludes that “...the benchmark we adopt will ... provide critical stability for both the long distance and exchange access markets.”¹⁴⁰ In the CLEC Access Order II, the Commission elaborated: “The Commission also sought to reduce existing regulatory arbitrage opportunities, spur efficient local competition, and avoid disrupting the development of competition in the local telecommunications market.”¹⁴¹ In fact, particularly in the RLEC areas, it is doing just the opposite.

96. The lack of fair access compensation allows PrairieWave’s incumbent and nonincumbent competitors (that today include cellular and VoIP service providers) who access its network to terminate calls with an unfair competitive advantage. They do not have to adjust their local service or long distance rates to the higher network costs of serving the area and, in fact, they actually have their rates subsidized by PrairieWave’s capped low access rates. They are essentially implementing business plans that depend upon these subsidies, subsidies that are not sustainable. These companies use the regulatory arbitrage created by non-cost based interstate access rates to “game” the RLEC access system and spur their own competitive price programs, which only further erodes the RLEC’s ability to maintain its revenues and, consequently, its network and remain competitive.

97. Notice what is occurring in the RLEC markets. Setting network access at rates that are far below the RLEC’s forward-looking economic costs is forcing the RLEC to either (i) absorb the missing revenue (thus sending inefficient and incorrect investment signals that result in discouraging competitive entry in additional small communities) or (ii) cross-subsidize its own competitors by attempting to increase local access rates or SLC charges (an option that is very limited, as explained above). This also sends an erroneous investment signal, this time to the incumbent and other competitors using the RLEC’s network at below forward looking economic costs. Worse, since these two signals are interdependent, they reinforce themselves, creating a capital investment inefficiency spiral that is dynamically unsustainable. It simultaneously destroys the RLEC capital base that is supporting the dependency while encouraging RLEC competitors to expand using business models based on faulty economic costs.

98. Moreover, this situation further distorts the determination of true operating and marginal costs for both the RLEC and its competitors, which interferes with the setting of consumer rates. Is it really fair to RLEC consumers to expect them to subsidize incumbents and other competitors because the RLEC is forced to increase local rates to offset the loss of access revenue?¹⁴² Does not the inability of a RLEC to recover its network access cost restrict its

¹⁴⁰ CLEC Access Order I, ¶ 44.

¹⁴¹ CLEC Access Order II, ¶ 74.

¹⁴² “...the existence of a subsidy introduces a distortion of its own because nonusers of a product [in this case, network access] are required to pay part of the cost for the users [the other carriers using the network to terminate their calls and data traffic].” See Sharkey, *The Theory of Natural Monopoly*, at p. 49. See, also, the fairness issues raised in Mitchell and Vogelsang, *Telecommunications Pricing, Theory and Practice*, p. 33.

ability to drive consumer prices down, an express goal of the 96 Act? And when the RLEC is no longer able to maintain its network due to a lack of adequate access revenue, how are its competitors going to replace that consumer access? And is not the likely result a disruption of service, a violation of universal service goals, and an increase in consumer rates? Who is going to pay for the uncompensated taking of the RLEC's network? In short, the market mechanism that is supposed to produce true, competitive rates in real time is short circuited and inoperable, and the consequences are potentially severe.

99. The resulting market entry signals, investment, and competitive pricing activities are inefficient and ultimately destabilizing, as has been vividly demonstrated over the past several years by the rapid rise and fall of the UNE based CLECs. This is not a new industry phenomenon. This same inequity in access revenue worked to undermine the early independent telephone companies in the 1900s.¹⁴³ Today you can also see this start to occur in the new flat rate calling plans from fast growing, national substitute service competitors like the cellular service providers and, most recently, the new VoIP companies. This is the direct result of the mandated use of "artificial" incumbent access rate caps as opposed to the application of true forward-looking economic cost concepts to access rate determinations.¹⁴⁴

100. As discussed above, the Commission has recognized the dangers of pricing access below forward looking economic costs and must act now to correct this situation in PrairieWave's situation. Economists also support the theory that unfair cross-subsidization occurs when rates are set below relevant costs of production.¹⁴⁵

¹⁴³ "Although AT&T began to liberalize its connection policy, the toll revenues derived from interconnection were not divided equitably with the independents. Specifically, the formula for sharing toll revenues [which at that time included network access] did not recognize the vital contribution that local facilities made to the provision of long distance. As a result, the independents did not receive adequate compensation for the local facilities that initiated and terminated long distance calls in their territories. This made them less profitable than the Bell System companies and, ultimately, less appealing to investors." Wilson, *Deregulating Telecommunications* at p. 17.

¹⁴⁴ The Interstate Commerce Commission created virtually identical rate distortion and capital flow problems in its early rate setting rules for interstate trucking. "...the inflexibility of the ICC may have intensified episodes of instability by preventing a rational restructuring of rates and the consequent flow of capital into the most productive sectors of the industry." Sharkey, *The Theory of Natural Monopoly*, at p. 27. This is exactly what is now occurring in PrairieWave's small community markets because of the use of incumbent based access rate caps instead of actual costs.

¹⁴⁵ See Sharkey, *The Theory of Natural Monopoly*, at p. 42: "...the test for cross-subsidization reduces to the constraint that revenues must cover incremental costs of production." Under the present incumbent rate caps, PrairieWave's network access revenues do not cover its proper share of network operating costs, and this leads directly to the subsidization of competitors using its network to terminate calls or data traffic.

The Rural Exception

101. The Commission's current structural method of addressing these matters is through the rural exemption. "We also adopt a rural exemption to our benchmark scheme, recognizing that a higher level of access charges is justified for certain CLECs serving truly rural areas."¹⁴⁶

"We conclude that the record supports the creation of a rural exemption to permit rural CLECs competing with non-rural ILECs to charge access rates above those charged by the competing ILEC. First, we note that such a device is consistent with the Commission's obligations, under section 254(d)(3) of the Act and section 706 of the 1996 Act, to encourage the deployment to rural areas of the infrastructure necessary to support advanced telecommunications services and of the services themselves. The record indicates that CLECs often are more likely to deploy in rural areas the new facilities capable of supporting advanced calling features and advanced telecommunications services than are non-rural ILECs, which are more likely first to deploy such facilities in their more concentrated, urban markets. Given the role that CLECs appear likely to play in bringing the benefits of new technologies to rural areas, we are reluctant to limit unnecessarily their spread by restricting them to the access rates of non-rural ILECs."¹⁴⁷

"We are persuaded by the CLEC comments indicating that they experience much higher costs, particularly loop costs, when serving a rural area with a diffuse customer base than they do when serving a more concentrated urban or suburban area. The CLECs argue that, lacking the lower-cost urban operations that non-rural ILECs can use to subsidize their rural operations, the CLECs should be permitted to charge more for access service, as do the small rural incumbents that charge the National Exchange Carrier Association (NECA) schedule rates. We note in this regard that a rural exemption will also create parity between the rural CLECs competing with NECA carriers and those competing with non-rural ILECs."¹⁴⁸

"Our intent is that this exemption will permit a CLEC to tariff access rates above the competing ILEC's only when the competing ILEC has broad-based operations that include concentrated, urban areas that allow it to subsidize its rural operations and therefore charge an artificially low rate for access to its rural customers. We conclude that the most effective and objective means of accomplishing this is to allow the rural exemption only to those CLECs that are

¹⁴⁶ CLEC Access Order I, ¶ 3.

¹⁴⁷ *Id.* at ¶ 65.

¹⁴⁸ *Id.* at ¶ 66.

competing with price-cap ILECs that do not qualify as “rural telephone companies” under the Act’s definition.”¹⁴⁹

102. This is precisely the situation that PrairieWave finds itself in, competing against Qwest and Frontier in its small community markets. However, while the Order recognizes the real problems faced by an RLEC in a situation like PrairieWave finds itself, it defines the companies eligible for the rural exemption so narrowly that PrairieWave cannot qualify. In order to reduce the costs of service to its small community markets, PrairieWave maintains a point of presence in Sioux Falls, South Dakota, a community in excess of 50,000 residents.¹⁵⁰ The Sioux Falls location was never intended to seek widespread access to a low cost, high-density market to subsidize rural operations. Rather, it is a combination of legacy customers from the prior ownership of PrairieWave by a large UNE-based reseller and the expansion of Sioux Falls via annexation that is dragging PrairieWave’s otherwise rural operations into the “Sioux Falls Market,” a situation that is obviously fact-specific and unique to PrairieWave and not anticipated nor discussed in the CLEC Access Orders. Yet it prevents PrairieWave from qualifying under the exemption.

103. The Rural Exemption, while theoretically attractive, is simply a remedy without effective relief. It is also totally unnecessary if the Commission uses forward-looking economic access cost studies as the basis for all RLEC access rates.

The Real Remedy

104. It is useful to stop for a moment and summarize what is happening in RLEC markets such as those served by PrairieWave. Essentially, the CLEC Access Orders have ignored the very real cost differences between large incumbent service areas and smaller communities and used incumbent access rates as proxies for RLEC rates, even though the incumbent rates are not set by competitive market interactions, especially in the smaller markets. This results in access rates that are far below actual forward looking economic costs. RLECs are unable to recover the appropriately allocated costs from incumbents and other competitors using their networks. This has distorted the proper functioning of market cost/price signals, with the following results:

- RLECs like PrairieWave are subsidizing incumbents and other competitors (or are forcing their subscribers to provide the subsidies via higher local service rates and charges).
- Consumer rates in smaller communities and rural areas are higher than they would otherwise be if network access rates were properly set.
- Capital investment decisions are being distorted, both by discouraging new competitive investment by RLECs and, conversely, by encouraging inefficient market decisions by

¹⁴⁹ *Id.* at ¶ 79.

¹⁵⁰ *See* CLEC Access Order I, ¶¶ 75-76.

incumbents and other competitors who use the RLEC networks to terminate calls or data transmissions at unfairly low rates. This operates to delay the introduction of new advanced technologies in RLEC markets and subsidizes the introduction of immature technologies like VoIP.

- RLEC financial viability is being threatened, as RLECs are for all practical purposes unable to pass through unpaid network access revenues to other revenue sources and are forced to simply absorb the unpaid network costs. This constrains RLEC access to capital.
- The combined impact of these affects is destabilizing the markets to the long-term detriment of consumers.

105. None of this should be surprising. As noted above, the Commission recognized the serious threat of all of these ramifications when it designed its initial rules for the “Rural Exemption”.¹⁵¹ However, as discussed in detail above, the “Rural Exception” is not properly structured to remedy these problems, at least in PrairieWave’s situation.

106. All of these harmful results flowing from the CLEC Access Orders can be remedied simply by returning to the Commission’s own economic analysis and setting network access rates on actual RLEC forward looking economic costs based on the unique factors for their particular geographic market area. This is precisely what is requested by PrairieWave’s filing. It is also precisely what the Commission has ordered as the appropriate way for small rate of return LECs to address disparities that result from the Commission’s ILEC Access Order:

“To avoid any undue hardship that may result from selecting a default allocator of 30 percent, rate-of-return carriers also will have the option to submit a cost study to establish the portion of their local switching costs attributable to line port costs. Carriers electing this approach must base their cost studies on geographically-averaged costs, and submit the cost study in support of the tariff filing relying on the cost study. Once a rate-of-return carrier has performed a cost study to support its tariff, it may rely on that cost study for subsequent tariff filings. A rate-of-return carrier electing to use a cost study for a tariff must use the cost study for all elements in the tariff.”¹⁵²

107. The Commission has repeatedly noted that small and rural carriers are offered relief under the 96 Act, and has often referred to these provisions as providing a “relief valve” for

¹⁵¹ The Commission has also recognized in its analysis of rate of return ILECs that rural and nonrural ILECs have very different operating costs. ILEC Access Order, ¶ 27.

¹⁵² *Id.* at ¶ 95. Once again, the application of rate of return LEC analysis to RLECs like PrairieWave makes much more sense than the imposition of incumbent proxy rate caps that bear little relationship to the RLEC network cost structures. Note that actual costs are also the basis on which the Commission decided its rules for price cap LECs. “These rate structure modifications are similar to reforms previously implemented for price cap carriers, **and will foster efficient pricing by permitting rate-of-return carriers to establish new, cost-causative rate elements.**” *Id.* at ¶ 107 [Emphasis added].

unanticipated impacts from the rules.¹⁵³ Cognizant of the potential for unforeseen impacts in the access area, the Commission recognized the need for similar relief in the CLEC Access Order I: “We stress, however, that the mechanism set out below is a transitional one; it is not designed as a permanent solution to the issues surrounding CLEC access charges.”¹⁵⁴ Commentators have also stressed the need to reevaluate regulation in light of actual results.¹⁵⁵ And the truth is that in the RLEC markets today, current network access rules are creating havoc.

108. The CLEC Access Order rules were intended as transitional solutions. But RLECs and specifically, PrairieWave, cannot afford to wait for months or years to pass by in a broad reconsideration of the RLEC access rules, a process which will undoubtedly be tied up into the overall legislative and regulatory reform now being discussed. Given the current and continuing economic harm to PrairieWave, the Commission should take this opportunity to correct the problems created for PrairieWave in its markets. It can do so by accepting PrairieWave’s interstate access tariff based on its market specific forward-looking economic access cost study and restore sensibility into the RLEC access rate process, at least in PrairieWave’s corner of the rural upper Midwest.

<<END>>

¹⁵³ See, for example, Local Competition Order, ¶¶ 199, 247, 697, 783, 934.

¹⁵⁴ CLEC Access Order I, ¶¶ 7. See, also, ¶¶ 15, 63. In CLEC Access Order II, the Commission specifically recognized that its general incumbent rate caps might prove inappropriate in an RLEC setting and exempted the petition of SouthEast Telephone, Inc. for a waiver of these rules from its final decision and resolution of other petitions for reconsideration and relief, pending further consideration under its waiver rules. CLEC Access Order II, fn. 117. Such relief was also considered appropriate by many of the large IXCs and other commenters. See *Id.* at fn. 131.

¹⁵⁵ “...it is one thing to change the rules of the game, it is quite another to ensure that the new rules will produce the desired results. Ultimately, the success of the pro-competitive regulation will be measured by the availability of enhanced services, the extent of investment in broadband facilities, and the degree of competition that emerges in local markets.” Wilson, *Deregulating Telecommunications* at p. 171. “Whether measured in terms of industry structure (the number and organization of firms competing to provide services) or in terms of firm behavior (competitive price setting, innovation, diversity, and quality of services) competition is now the standard for measuring success.” *Id.* at p. 279.