PUBLIC NOTICE

September 15, 2003

FCC RELEASES STAFF WORKING PAPER
ADDRESSING ISSUES RELATED TO TELRIC PRICING RULES

The Federal Communications Commission's Office of Strategic Planning and Policy Analysis today released a staff working paper that addresses issues related to the Commission's TELRIC pricing rules.

The paper, OSP Working Paper No. 40, entitled "Dynamic Pricing and Investment from Static Proxy Models," evaluates the use of static computer cost models and cost studies typically used by regulators in setting forward-looking prices, and also seeks to address some of the issues raised by critics of TELRIC.[1]

It was written by Professor David M. Mandy, Department of Economics, University of Missouri and William W. Sharkey, Senior Economist in the Office of Strategic Planning and Policy Analysis. The views expressed in this paper are those of the authors alone and do not necessarily reflect the views of the Federal Communications Commission, any Commissioners, or other staff.

Section 2 of the paper addresses the argument that periodic recalculation of TELRIC prices prevents incumbents from recovering the cost of their investment.

It shows that if investment costs are falling over time, and the period between TELRIC price adjustments is shorter than the assumed asset life, then traditional TELRIC pricing will not permit incumbents to recover the cost of their investment. It then shows that when investment costs are rising over time, TELRIC pricing will result in an over-recovery of investment costs.

The paper explains that in either of these situations, it is possible to compute a simple correction factor, such that the corrected TELRIC prices follow the time path of underlying investment costs and simultaneously recover the firm's investment cost.

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[1] In the present context, a static cost model is one which does not explicitly take account of the way that investments are made at different points in time. Instead such a model assumes that a one time investment is made to serve all current and expected future demand.

Section 3 of the paper examines a carrier's cost minimizing investment plan in a dynamic environment with large fixed investment costs.

This section of the paper explicitly computes a cost minimizing investment plan for an efficient firm under two different assumptions about asset obsolescence, and various assumptions about other relevant parameters, including the rate of change of investment cost, the rate of growth of demand and the cost of capital.

It then compares the time path of prices which result from a particular implementation of TELRIC pricing with the time path of prices that would occur in a "contestable" market, which may be simply defined as a market in which entry barriers are absent.

While the section does not recommend specific input prices for cost models, it is directly relevant to the selection of forward-looking fill factors for such models. As such, it may be used to evaluate the arguments of some incumbents that state commissions have set unrealistically high fill factors.

It also provides a simple framework in which to compare pricing rules derived from static cost models with pricing rules derived from dynamic investment decisions made over time.

The paper is available in either Microsoft Word or Adobe Acrobat format on the FCC Web site, www.fcc.gov/osp.

WC DOCKET NO. 03-173
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