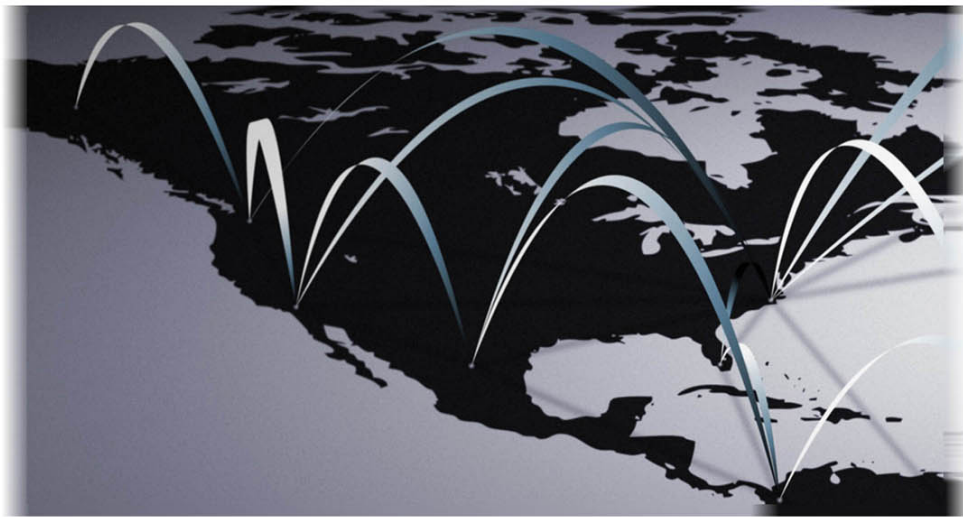


WHAT'S AT STAKE AT THE FCC ON UNE'S:
***ENSURING SUSTAINABLE
COMPETITION***



New Millennium Research Council

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Preface

This report is a project of the New Millennium Research Council (NMRC), which works to foster policy research focused on developing workable, real-world solutions to the issues facing policy makers, primarily in the fields of telecommunications and technology. The council consists of independent academics and researchers who are experts in their fields. Both seated experts and invited scholars author NMRC reports.

During the past year, the NMRC has investigated a range of issues related to competition in the telecommunications industry. The NMRC has also sponsored a number of roundtable events in Washington, D.C., and legislative briefings on the subject.¹

In this report, the NMRC continues its investigation, examining whether the current regulatory pricing model known as UNE-P (or Unbundled Network Elements Platform) is promoting investment in advanced telecommunications infrastructure. Specifically, whether the existing regulatory framework is contributing to the goal of the 1996 Telecommunications Act—to promote vigorous facilities-based competition while creating incentives for long term investment in advanced telecommunications infrastructure.

The NMRC has published this report at a very important crossroads for the industry. The Federal Communications Commission (FCC) is nearing a decision in the Triennial Review of unbundling obligations of local exchange carriers, a decision that will have a significant impact upon both the telecommunications industry and the economy as a whole.

This report presents the views of five telecommunications experts, who in their own unique voice offer insightful perspectives on existing UNE rules and their impact for competition and network investment. Specifically, that the downturn in the telecommunications industry has been heightened and prolonged by regulation that favors quick entry over sustainable, long-term competition. As John Malone, President and CEO of Eastern Management Group writes, *“UNE-P didn’t bring down the communications market, but like a stroke delivered after a fall down a flight of stairs, it has kept the victim on the floor.”*

➤ **UNE-P was designed as a temporary solution to encourage competition. It has served its initial purpose and is no longer a sustainable business model.**

As Matthew D. Bennett, Policy Director of the Alliance for Public Technology, notes, *“UNE’s are a temporary fix. In the short term, unbundling has encouraged a rise in competition statistics, but it has done immeasurable damage to the long-term prospects for deploying advanced services. It has discouraged network upgrades in urban and suburban areas and led to practically non-existent investment in rural and underserved communities.”* Competitive Local Exchange Carriers (CLECs) are now able to compete without the need for UNE pricing. In addition, wireless and cable technologies are taking away customers from traditional wireline voice and data services. Malone writes, *“UNE-P is not a sustainable business model. Companies built on UNE-P have no assets, no competitive differentiation, and no control over their future...”* This situation can be avoided by switching to facilities-based competition. CLECs will adapt, or revert to the facilities based networks they have abandoned due to UNE-P. Fewer, stronger competitors on a firmer financial footing will provide abundant consumer choices. As Solveig Singleton, Senior Policy Analyst with the Competitive Enterprise Institute writes, *“Observers with little reason to butter up local phone companies are calling for unbundling to be scaled back.”*

➤ **UNE-P discourages investment in the public switched network and in broadband services.**

It is a matter of economic reality that telecommunications networks are capital intensive, and the financial community has no tolerance for investments without reasonable expectations of a competitive return. Despite noble intentions, public policies that promise ubiquity in the deployment of advanced

¹ See our website at www.newmillenniumresearch.org for copies of the reports and transcripts of the events.

telecommunications capability to all Americans do not drive investment. Stephen B. Pociask, President of TeleNomic Research, writes, *“While UNE-P was created to jumpstart competition, ironically...it has actually discouraged facilities-based competition.”* Randolph J. May, Senior Fellow and Director of Communications Policy Studies at the Progress and Freedom Foundation writes, *“For if the Commission chooses [Static Regulated Competition] embodying an indefinite future of ‘managed competition’, investment in advanced telecommunications facilities and equipment and innovative new services will be impaired.”*

The unbundling of broadband elements has also directly inhibited the growth of consumer access to high-speed Internet services. Singleton writes, *“A realistic grasp of economic forces at work beyond the FCC will push the agency in the direction of scaling back unbundling for voice and avoiding it for broadband...Uncertainties of consumer demand, especially for broadband, mean that investors will need more reward to take the risk.”* Incumbent local exchange carriers (ILECs) are positioned to provide such services but the unbundling of broadband elements such as line-sharing and packet-switching are preventing faster deployment. The ILECs’ Digital Subscriber Line (DSL) services have not been able to effectively compete with cable Internet services, which do not face the same regulations. As a result, consumers have fewer broadband choices and pay higher prices. Pociask notes, *“Changes limiting the extent of unbundling for high-speed Internet services, as well as rules that provide symmetrical regulatory treatment of broadband investments, would bring relief to broadband investors.”*

➤ **UNE-P seriously inhibits facilities-based competition.**

Incumbent phone companies are reluctant to invest in advanced telecommunications capabilities for fear that the FCC will require them to offer the modernized network to competitors at the TELRIC discount. The Commission’s sole reliance on UNE resale entry is thus impeding the facilities-based competition that is necessary to achieve the ubiquitous advanced telecommunications deployment that Section 706 of the ‘96 Act requires. As FCC Chairman Powell has noted, facilities-based competition reduces consumers’ dependence on incumbent networks, provides truly differentiated choice and a redundant, more dependable infrastructure. Pociask writes, *“The fact is that UNE prices are being set so low they have effectively become a subsidy for CLECs paid by their competitors, the ILECs.”*

➤ **UNE-P erodes jobs.**

Without a fair return on investment, it becomes increasingly difficult to maintain current workforce levels. In the past 18 months alone, the communications and information technology industry has lost more than 500,000 jobs. May writes, *“This stifling of investment obviously will have a continuing adverse impact on jobs in the already depressed telecom and high-tech sectors and thus on the overall economy.”* By contrast, a regulatory environment that removes regulatory barriers and encourages investment can create new employment opportunities.

According to a February 25, 2002, NMRC study, it is estimated that full broadband deployment would result in the creation of 1.2 million new jobs. Information technology jobs also pay, on average, 85% more than other jobs. *“Without UNE-P, manufacturers and software companies will step in and provide the products required of the facilities-based-carriers. The impact will create jobs, profit, and a needed boost to the economy.”* (Malone) Greater investment in a nationwide broadband network (from the release of UNE-P capital) would generate a significant number of high-quality jobs.

➤ **UNE-P competition requires investments by the dominant carriers, whose cutbacks not only threaten future competitors’ access, but the economy as a whole.**

Malone writes, *“The uneven playing field created by UNE-P has motivated the incumbent telephone carriers to scale back almost all network expansion.”* While the current regulatory framework eliminates the economies of scope and scale and discourages investment in more sophisticated networks, it encourages investment in unregulated services in the U.S. and abroad. Pociask notes, *“Falling prices have propped up weak CLECs, now dependent upon subsidized leasing and overcrowded the market with competitors,*

making the whole lot worse off. ” The downward trend in pricing encourages shareholders to shift their assets to competitors where the returns are greater, which could lead to higher rates. Singleton notes, “...the FCC needs to pay attention to forces like investment incentives and demand.”

The FCC can stimulate investment in new and advanced networks, by eliminating rules that restrict local phone companies from competing with the dominant broadband players. Removing unbundling requirements and encouraging competition will encourage the construction of alternative networks so that consumers can have a real choice of provider. This action will also spur investment in and deployment of broadband, enabling more Americans to access advanced telecommunications services.

The five noted telecommunications experts that contributed to this report represent a broad cross section of perspectives.

- **Matthew D. Bennett** is Policy Director of the Alliance for Public Technology, a non-profit membership organization concerned with fostering access to affordable and useable information services and technologies to all people. He educates and advocates for policies that expedite the deployment of advanced telecommunications services to all sectors of society, working with and establishing coalitions to spur involvement in telecommunications issues. Before joining APT, Mr. Bennett served as Senior Associate for Communications and Government Relations at the Alliance for Community Media.
- **John Malone** is President and CEO of Eastern Management Group, one of the oldest and largest management consulting firms focused exclusively on the communications industry. He provides professional services to leading edge communications companies and governmental institutions worldwide. He and his firm have advised every major telecommunications manufacturer, software company and carrier in North America, Asia, Latin America and Europe. John Malone has been professionally involved with the telecommunications industry for more than 30 years.
- **Randolph J. May** is Senior Fellow and Director of Communications Policy Studies at the Progress and Freedom Foundation, a market-oriented think tank that promotes innovative policy solutions for the digital age. He examines policies relating to deregulation of the competitive telecommunications industry and the implications of competition for reform of the FCC. Prior to joining PFF, he was a partner with Sutherland Asbill & Brennan in Washington, DC, specializing in communications and administrative law. He has served as Associate General Counsel of the FCC and as a Member of the Administrative Conference of the U.S. He has published more than thirty-five articles on a wide variety of topics ranging from communications law to constitutional theory. He is an adjunct professor of law at George Mason University School of Law.
- **Stephen B. Pociask** is President of TeleNomic Research, an economic and strategic consulting firm focusing in research on Information Technology, Internet and Telecommunications markets. Over the past 20 years, his studies have been filed with both federal and state regulatory commissions. He has appeared before the FCC and testified before Congress on Internet and broadband legislation. Before founding TeleNomic Research, Mr. Pociask served as Chief Economist and Executive Vice President for a DC-Based economic consulting firm.
- **Solveig Singleton** is Senior Policy Analyst with the Competitive Enterprise Institute, a non-profit public policy organization dedicated to the principles of free enterprise and limited government. Ms. Singleton is the former director of information studies for the Cato Institute. She served as vice chair of publications for the Telecommunications and Electronic Media Practice Group of the

Federalist Society for Law & Public Policy Studies from 1996-1999. Her articles have appeared in *The Washington Post*, *The Philadelphia Inquirer*, *The Wall Street Journal*, *The Journal of Commerce*, *Internet Underground*, and *Hot-Wired*, as well as academic journals. She is the co-editor of two books, Regulators' Revenge (1998) and Economic Casualties (1999).

The New Millennium Research Council wishes to thank the authors for their time and insight on this critical and timely issue.

February 2003

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Creating a Competitive Future for All

Matthew D. Bennett
Policy Director
Alliance for Public Technology

Everything has changed in the world of advanced telecommunications and technology except the need for consumer access. The new environment is an unknown quantity, with technology evolving to a stage never before imagined and a marketplace that has grown enormously, but faces economic uncertainty. The benefits for consumers are many, but only if the services are affordable, accessible and ubiquitous. Today, there are still shortfalls in the reach of broadband and advanced services. The Federal Communications Commission is now faced with an extraordinary opportunity to promote universal access and widespread deployment and bring all consumers into this exciting telecommunications future.

The Commission should not lose sight of the consumer interest in its Triennial review of unbundling obligations (UNE). The goal of the Telecommunications Act of 1996, stated in its preamble, is, "To promote competition and...encourage the rapid deployment of new telecommunications technologies." In addition, Section 706 of the Act, which APT took a lead role in crafting, provides regulatory flexibility to encourage deployment of advanced telecommunications services and remove barriers to infrastructure investment. The current unbundling regime has not significantly contributed to any of these goals, but the FCC now has the chance to bring benefits to all consumers by creating a truly competitive telecommunications landscape.

To achieve the twin goals of competition and deployment, the Commission must take swift action and clear the way for a facilities-based competition model in telecommunications. Today, the UNE regime discourages infrastructure investment and creates a resale form of competition that has a negative effect on the long-term growth of telecommunications services. By allowing competitors to lease facilities at below-cost rates, there are no incentives for the incumbent to invest in capital-intensive new technologies or for competitors to build their own networks.

UNE's are a temporary fix. In the short term, unbundling has encouraged a rise in competition statistics, but it has done immeasurable damage to the long-term prospects for deploying advanced services. It has discouraged network upgrades in urban and suburban areas and led to practically non-existent investment in rural and underserved communities. Competitors using the UNE platform traditionally target lucrative business customers, ignoring millions of American consumers.

Discouraging infrastructure investment does not help consumers. Creating false competition based on a resale model does not help consumers. Continuing the UNE regime in the broadband world will not help consumers. In fact, the UNE rules will dramatically slow the arrival of true broadband services; the ubiquitous, two-way connections made possible by technologies such as fiber to the home.

Given the problems created by the UNE regime, the Commission has a great deal at stake in the current proceedings. The Commission needs to take a new approach, one that values innovation and investment, and not creation of a competition structure that only benefits a small segment of the country.

Encouraging robust, facilities-based competition and deployment of advanced services requires a regulatory structure that is flexible and forward-looking. Removing outdated rules that only hinder the development of next generation telecommunication services by enacting policies designed to enhance competition and investment by both incumbents and competitors is a critical step.

Such a regime should include the following principles: (1) Broadband networks and other new investments must be excluded from unbundling; (2) Those elements, such as switching, that are currently available in

abundance in the marketplace should not be included in the list of available UNEs; (3) A workable transition period must be established to ensure services remain available to consumers and competitors are not unduly harmed; (4) Strict performance standards and monitoring devices must be created to ensure service quality and efficient remedies must be available in response to violations; (5) The regulations must be stable across jurisdictions. The Commission alone should formulate the list of elements included in unbundling, while the states continue to possess authority over pricing and performance monitoring.

By creating such a forward-looking regulatory structure, one that values investment and deployment of advanced services, the Commission can deliver real choices to consumers. Expanding facilities-based competition will only provide more options at better prices. Additionally, increased investment will improve the fortunes of the telecommunications economy and create opportunities for new growth and new jobs.

By adopting the pro-consumer principles above, the Commission can encourage deployment and infrastructure investment, allowing consumers to have greater access to services and applications that bring better and more affordable health care to all citizens, expand educational opportunities for lifelong learning, enable people with disabilities to function in ways they otherwise could not, create opportunities for jobs and economic advancement, make government more responsive to all citizens and simplify access to all forms of communications technology.

In order to achieve the important goals of the Telecommunications Act and provide consumers with real choices and opportunities, the UNE regime must be reformed. Long term growth and development of the telecommunications infrastructure is critical to our nation's future, but it will not progress as needed if the regulations stifle innovation and discourage investment. Consumers deserve access to every possible form of telecommunications services and the Commission should seize this important opportunity to create a vibrant telecommunications future for all.

The Benefits of Displacing UNE-P

John Malone
President and CEO
Eastern Management Group

When Congress passed legislation, which became the Telecommunications Act of 1996, it set in motion the largest communications undertaking the world ever witnessed. Thousands of new carriers emerged, erecting massive, robust networks, many of which shamed the older traditional networks of established telephone companies in efficiency, speed, and ability to deliver new services.

Venture capitalists and Wall Street funded such differentiated business plans predicated on the all too familiar “better, faster, cheaper” principles of commerce. The new communications age was off and running, and before the roof caved in, venture capitalists were infusing close to \$500 million a day into the industry, not just supporting new carriers, but hundreds of start-up manufacturers and software companies that underpin the industry. Add to that new debt, and some \$2 trillion went to enable the lift-off of the Telecommunications Act.

Today, seven years since the Act, here is some of what one observes among the charred remains. Two trillion dollars of market cap, a half million telecommunications jobs, and \$800 billion in debt have evaporated. Moribund equipment and software manufacturers, whose sales have dried up, are waiting to see what’s next. Any carriers with cash are deploying capex dollars in quantities barely capable of sustaining their existing networks; no one is building out new networks; no company in their right mind provides guidance any more; and yes, UNE-P is here.

UNE-P didn’t bring down the communications market, but like a stroke delivered after a fall down a flight of stairs, it has kept the victim on the floor.

Clear and simple, UNE-P is arbitrage. Competitors buy telephone company facilities for very little money, add a small mark up, and sell uninspired same-old-services for less than it cost the phone company to construct them in the first place. What is insidious about UNE-P is that the prices for these unbundled network element platforms are for the most part chosen by the state regulators with little regard or understanding of what it cost the telephone company to construct them in the first place. To some it may look as if everyone wins at this game (competitors, consumers, state governments) unless, that is, you think that the phone company deserves to win too, which it doesn’t.

When I was young some bullies pinned me down, took my new Converse sneakers, ran down the street and hocked them for a tidy profit. Had they flipped me a quarter for my trouble, the arbitrage would hardly have compensated me for the lost investment. That’s UNE-P.

UNE-P is not a sustainable business model. Companies built on UNE-P have no assets, no competitive differentiation, and no control over their future (at a moment’s notice the same government who gave UNE-P can take it away). For this reason, and I know from experience, venture capitalists and private equity firms throw away business plans based on UNE-P faster than a poor auditioner for American Idol is ushered off the set. Such asset-less companies have no future and there is little chance for investors to get liquid.

Facilities-based carriers are hurt by UNE-P. There are zero barriers to entry in any market a facilities-based carrier might otherwise enter, but won’t, and no protection in markets the facilities-based carrier has already gone to the trouble to build-out. New facilities-free carriers can squat, buy UNE-P from the incumbent

telephone company at prices the facilities-based carrier cannot match, and take customers. It's no wonder that the share prices of many facilities carriers today are close to zero.

UNE-P has not generated one dollar of additional revenue for any manufacturer of central office switches, frames, network operating or management equipment, software or fiber optic cable. Just ask the hundreds of companies who make them.

So why has UNE-P lasted? The first answer is that every state wants to please its consumers. Holding down phone rates does that. They also want to report that the state is enjoying the fruits of the Act. That can be done if many competitors are on the scene. Whether the competitor is facilities-based or not, the image is that jobs are being created, and the economy is benefiting as competitors arrive. Half of all states have forced down UNE-P rates to such levels that arbitragers cannot stay away.

Now what happens if UNE-P goes away? The FCC's Chairman Powell has made no secret of the fact that he doesn't believe UNE-P to be a sustainable business model, or healthy for the industry in the long term. When UNE-P goes away, as it must, the industry will be better off for the effort to rid it. Some carriers, whose businesses have been constructed entirely on UNE-P may sell-off their installed base of customers to facilities-based carriers. Others, who are already largely facilities-based carriers with some UNE-P, may refocus to add more customers on their existing networks. Yet a third UNE-P dependent carrier group may have sufficient UNE-P customers in given geographies to warrant purchasing new switches, or buying concentrators to back-haul traffic to an existing switch. These options are viable today in the absence of UNE-P since the price of switches and concentrators have declined substantially within the past year. New small switches can be acquired for under \$50 thousand and concentrators sell for under \$30 thousand, equating to \$50 dollars per line (DS-0) for a central office and \$30 per line (DS-0) for a concentrator.

Without UNE-P, manufacturers and software companies will step in and provide the products required of the facilities-based carriers. The impact will create jobs, profit, and a needed boost to the economy.

The uneven playing field created by UNE-P has motivated the incumbent telephone carriers to scale back almost all network expansion. At the apex of the telecommunications boom, these companies spent more than 30 percent of their revenues on network construction and maintenance. Thanks in large measure to UNE-P, these numbers are vastly lower today. Investing in a network makes little sense when it cannot promise a return. Removing UNE-P will elevate construction by the carriers, improve their earnings and create a beneficial domino effect for the industry.

The FCC And Telecom Recovery: A Scorecard For Evaluating the New Rules

Randolph J. May*
Senior Fellow and Director of Communications Policy Studies
Progress and Freedom Foundation

It is not hyperbole to say that the Federal Communications Commission is truly at an important crossroads. Indeed, to suggest anything less would be misleading. Acting in three separate proceedings, the FCC soon will issue new rules that will be touted as reducing regulation of telecommunications and information services. Seven years after the passage of the Telecommunications Act of 1996, real deregulation is coming too late. The question is: Will it also be too little to spur a recovery in the depressed telecommunications and high tech-sectors?

The three proceedings in which the Commission will issue new rules are: The *UNE Triennial Review Proceeding*², the *Wireline Broadband Proceeding*,³ and the *Cable High-Speed Access Proceeding*.⁴ The *UNE Triennial Review* will determine the extent to which, and for how long, the incumbent local exchange carriers, such as SBC and Verizon, will be required to share every element of their local networks with competitors at regulated below-market prices. And the other two, the *Wireline Broadband* and *Cable High-Speed Access* proceedings will determine if telephone and cable broadband service providers will be able to offer their competitive services free from regulatorily-mandated capacity sharing requirements and price controls.

In reality, in making the crucial decisions, the Commission will be forced to choose between two competing visions of telecommunications regulation:

Vision 1—Static Regulated Competition—In this vision, communications services are provided essentially in a natural monopoly environment, and this is likely to be the case indefinitely. So the question for regulators is how to continue to shape regulation to guarantee “competitor access” to incumbent facilities and a “level playing field” for all market participants.

Vision 2—Dynamic Deregulation—In this vision, communications services are provided in what is rapidly becoming a naturally competitive environment that encourages even more competition, investment, and innovation. So the question for regulators is how to transition without undue delay to a much less regulatory framework, leaving regulation in place only where necessary for the remaining “pockets of monopoly.”

To be sure, the two visions spelled out above may be oversimplified at the margins. But in a very real sense, they do, in fact, describe two divergent paths between which the Commission must choose in confronting the issues in the three major proceedings.

* Randolph J. May is Senior Fellow and Director of Communications Policy Studies at The Progress & Freedom Foundation, Washington, DC. The views expressed are his own. This paper is adapted from a longer version published by The Progress & Freedom Foundation entitled, “The FCC and Telecom Recovery: A Scorecard for Evaluating the New Rules,” *Progress on Point*, Release 10.2, January 2003.

² *In the Matter of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers; Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*; Deployment of Wireline Services Offering Advanced Telecommunications Capability, FCC 01-361, CC Docket No. 01-338, released December 20, 2001.

³ *Review of the Appropriate Framework for Broadband Access to the Internet Over Wireline Facilities*, FCC 02-485, CC Docket No. 02-33, released February 15, 2002.

⁴ *Inquiry Concerning High-Speed Access to the Internet Over Cable and Other Facilities*, GN Docket No. 00-185, released March 15, 2002.

In order to evaluate whether the Commission's actions are pro-competitive and deregulatory (that is, consistent with the Dynamic Deregulation Vision) or anti-competitive and pro-regulatory (that is, consistent with the Static Regulated Competition Vision), it is useful to have in mind a set of "benchmarks". Here are the benchmarks that I propose for the scorecard:

- **Unbundling And Sharing Should Not Be Required For Newly Installed Fiber Or Other Non-Copper Facilities**
- **Regardless Of Technology Platform, Broadband Services Should Not Be Subject To Unbundling and Sharing Requirements Or Computer-II-Type Separation Requirements**
- **Local Switching Should Be Removed Promptly From The Unbundling And Sharing Regime**
- **Inter-Office Transport and High Capacity Loops Should Be Removed Promptly From The Unbundling And Sharing Regime And "Special Access" Should Not Be Re-Regulated**
- **A Presumptive Sunset Regime With Competitive Triggers Should Be Established For The Removal Of Copper Local Loops From The Unbundling And Sharing Requirements**
- **The Commission Should Preempt The States From Mandating Unbundling And Sharing Requirements That Exceed The Scope Of The Federal Obligations**
- **Elements That Have Been Removed From The Unbundling And Sharing Regime Should Not Be Considered On The "Competitive Checklist" For Evaluating Section 271 Applications**

No doubt, there will be great pressure from outside the Commission, as there always is, for the agency to "split the baby" among the contending sides, to let the battle-hardened contestants walk away with their own victories. And there will be pressure from inside the Portals as well for only "incremental" or "moderate" action. After all, if the Commission does, finally, set out determinedly on a truly deregulatory course, it will be deciding that in the future the agency should play a much less intrusive and more modest role than it has in the past. Federal agencies are not by nature immodest in their regulatory ambitions.

So, whether or not the Commission puts it this straightforwardly, as the Commission makes its choices in the *UNE Triennial*, *Wireline Broadband*, and *Cable High-Speed Access* proceedings, it necessarily will be deciding between the pro-regulatory Vision 1, which leads inexorably down a path of false, not sustainable, competition, or the deregulatory Vision 2, which leads to long-term sustainable competition. In this case, actions that may win accolades if characterized as "incremental", "moderate", or "balanced" almost certainly, in reality, will place the Commission firmly on the Vision 1 path.

And make no mistake. It matters greatly which path the Commission chooses. For if the Commission chooses Vision 1 embodying an indefinite future of "managed competition," investment in advanced telecommunications facilities and equipment and innovative new services will be impaired. This is true for incumbent providers, whether they are wireline telephone companies or cable companies or whatever, and for new entrants as well, whether they are wireline, wireless, fiber, or satellite providers. This stifling of investment obviously will have a continuing adverse impact on jobs in the already-depressed telecom and high-tech sectors and thus on the overall economy.

There is little purpose here to be served by reciting facts and figures detailing the extent of the telecom meltdown. The Commission surely has in mind the state of the industry. It is enough to quote from the

opening of a November 25 letter to FCC Chairman Michael Powell from Matthew Flanigan, President of the Telecommunications Industry Association:

[T]he dramatic downturn in the telecommunications sector has led to more than 500,000 job losses, \$1 trillion in corporate debt and nearly \$2 trillion in market valuation losses in the telecommunications industry alone since 2000. These developments have precipitated an unprecedented slashing of research and development budgets that seriously threatens the future of industry innovation, our global leadership in technology, and, in some very important respects, the very security of the United States.⁵

The Commission's past actions implementing the Telecommunications Act of 1996 in an excessively regulatory way surely are not *solely* responsible for the current telecom meltdown. But they almost certainly have played a *contributory* role.⁶ If the Commission acts in these proceedings in a way, judged by the benchmarks set forth in this paper, that is consistent with the Dynamic Deregulation Vision, it most likely will play a *contributory* role in speeding a recovery in the telecommunications and high-tech sectors—to the benefit of consumers and the overall economy.

Back in 1998, in an eloquent essay entitled, “Communications Policy Leadership for the Next Century,” then-Commissioner Powell described a dynamic communications industry in the process of being transformed by the rapid technological change brought about by the digital revolution.⁷ Chairman Powell said: “Policymakers...are fast approaching *moments of truth* in which we will have to decide whether services similar to those offered over one medium should be regulated in the same manner as new services offered over another medium—or whether new services should be regulated at all.”⁸ He asked whether the Commission should allow “traditional wireline telephone companies to take root in the rich soil of deregulation to grow innovative services as have Internet service providers?”⁹ And he then declared that: “As technology erases the differences between these services, communications policy leaders will need to reconcile conflicting regulatory approaches in a way that reinforces forward-looking, pro-competitive approaches and *discards outdated approaches*.”¹⁰

That was 1998, after the Commission had put in place an overly regulatory and unduly burdensome regime to implement the intended supposedly “pro-competitive, deregulatory national policy framework” of the Telecommunications Act of 1996.¹¹ It would be easy to belabor the point, but, suffice it to say, that now, in 2003, the Commission surely is facing “moments of truth.”

The benchmarks set forth above provide a guide for evaluating whether the Commission's decisions in the three major proceedings—*UNE Triennial Review*, *Wireline Broadband*, and *Cable High-Speed Access*—meet the minimum requirements necessary to qualify as consistent with the Dynamic Deregulation Vision, or whether, instead, the Commission opts for the Static Regulated Competition Vision.

It is my belief that not only the communications industry, but all of the country's consumers, will benefit if the Commission scores well.

⁵ Letter from Matthew Flanigan to Michael Powell, FCC, November 25, 2002.

⁶ See Larry F. Darby, Jeffrey A. Eisenach, and Joseph S. Kraemer, “The CLEC Experiment: Anatomy of a Meltdown,” *Progress on Point* 9.23 (September 2002) (Washington, D.C.: The Progress & Freedom Foundation), at 18-20.

⁷ 50 FEDERAL COMM. L. J. 529 (1998).

⁸ *Id.*, at 544.

⁹ *Id.* (Emphasis added.)

¹⁰ *Id.* (Emphasis added.)

¹¹ See H. R. CONF. REP. NO. 104-458 AT 113 (1996), *reprinted in* 1996 U.S.C.C. A124, 124.

Fostering Telecommunications Competition: Renters vs. Builders

Stephen B. Pociask
President
TeleNomic Research

FCC Action Expected

The Federal Communications Commission (FCC) is considering ending a number of onerous regulations that have discouraged investment and led to job losses in telecommunications and broadband sectors. This month, the FCC is expected to rethink its rules for unbundled network elements (UNEs), those network components that competitive local exchange companies (CLECs) lease from incumbent local exchange companies (ILECs). Indications are that the FCC is looking in the right direction for change. One possible change that the FCC is considering is the phasing out of UNE-P, a complete recombination of UNEs that form local telephone services. While UNE-P was created to jumpstart competition, ironically, as will be discussed, it has actually discouraged facility-based competition.

Another possible FCC decision would limit the extent of UNE services based on their availability in the market. It may be, for example, unnecessary to require ILECs to offer a switching element to its competitors when some competitors already own switches. In many markets, switching is abundantly available to even the smallest of carriers. The elimination of just one element, such as switching, would have the same effect as eliminating UNE-P.

Changes limiting the extent of unbundling for high-speed Internet services, as well as rules that provide symmetrical regulatory treatment of broadband investments, would bring relief to broadband investors. Current regulatory rules require ILECs that build broadband infrastructure to share them with competitors, and share them at prices that do not fully compensate the ILECs for their investment. This explains why high-speed services are not being deployed as fast in the U.S. as they are in some countries.¹² Moreover, cable operators are not subject to the same unbundling and sharing requirements, which explains why high-speed cable services account for 70% of broadband services in the U.S.

These changes, if announced by the FCC, would encourage CLECs to build alternative networks, and be a boost for consumers and the economy. However, the FCC may not deal with the biggest problem – namely, the fact that UNE prices have been set too low, creating a market of renters, not builders.

Background

In order to spur competitive entry into the local telephone market, the Telecommunications Act of 1996 permitted CLECs to enter and provide local telephone services to consumers. The hope was that these CLECs would eventually build their own networks. Because building alternative networks would take many years, the Act permitted CLECs to resell the ILECs' services, which allowed them to provide phone services immediately to consumers. The Act also permitted the CLECs to lease UNEs from the ILECs' networks. Leasing UNEs would allow CLECs to build portions of their network, while using portions of the ILECs' network. In theory, this would help migrate CLEC customers from resale to CLEC-owned networks. Over time, consumers would benefit from increased competition, as the invisible *hand* of market forces would replace the heavy hand of industry regulation. At least, that was the thinking.

¹² Stephen Pociask, "Putting Broadband on High Speed," Economic Policy Institute, Washington, DC, 2002.

Regulatory Malpractice

In setting the prices for these UNEs, regulatory commissions often relied on hypothetical bottoms-up cost models. These models typically excluded some overhead costs, ignored regulatory costs, overlooked actual and prudent investments, missed the recovery of embedded costs, and undervalued the risk of plant obsolescence. Another problem regulators created was allowing CLECs to recombine UNEs into UNE-P service, effectively replicating the resale service called for by the Act, but at half the cost called for by the Act.

The fact is that UNE prices are being set so low they have effectively become a subsidy for CLECs paid by their competitors, the ILECs. One study calculated that TELRIC costs would need to be marked up 3.3 times in order to recover the ILECs' sunk costs and risks.¹³ Several studies have shown that UNE prices were so low that ILECs could not survive solely as wholesale companies.¹⁴ Another analysis compared UNE revenues to retail end-user revenues and concluded that UNEs give the ILECs only 42% of the revenue they would have received from their retail operations.¹⁵ Still another study estimated that it would take twenty years of productivity-based price reductions to reach the one-time effect of an immediate shift to these low UNE prices.¹⁶

Justifying these artificially low prices as a way to jumpstart competition, regulators have continued to drop UNE prices. Falling prices have propped up weak CLECs, now dependent upon subsidized leasing, and overcrowded the market with competitors, making the whole lot worse off. And the price reductions continue – last year, several state commissions made sharp reductions to the ILEC's UNE-P rates, including 40% and 45% in California and New Jersey, respectively.

Renters vs. Builders

The result of artificially low UNE prices means that CLECs can lease the ILECs' facilities at rates that are cheaper than building their own networks. One time facility-based competitors have now adopted the renters' UNE-P model and stopped investing in local telecommunications infrastructure. In short, regulation is subverting market forces and undermining those CLECs that took great financial risk to build competitive networks. As the chart below shows, the increase in leased lines has come at the expense of CLEC-owned and resale lines. The original premise that CLECs would eventually transition to facilities competitors has not come true, thanks to artificially low UNE prices.¹⁷

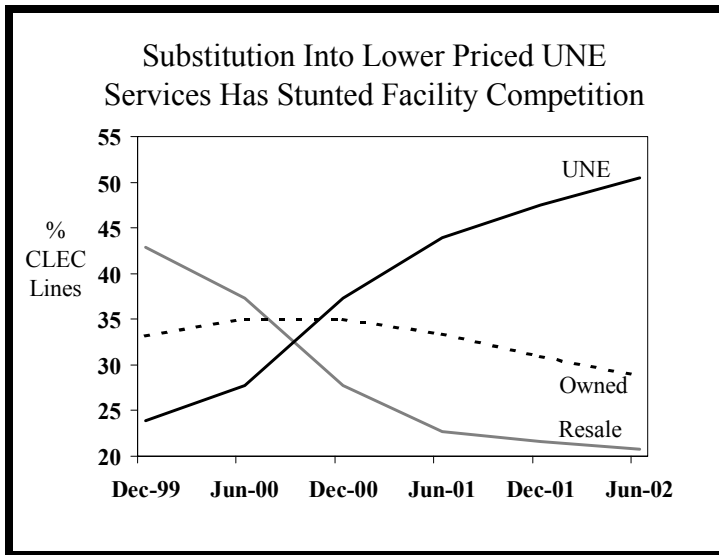
¹³ Jerry Hausman, "Valuing the Effect of Regulation on New Services in Telecommunications," *Brookings Papers on Economic Activity: Microeconomics*, Brookings Institute, Washington, D.C., 1997, pp. 1-54.

¹⁴ Stephen Pociask, "Competition at Bargain Prices," published as "Two Degrees of Structural Separation," *America's Network*, Vol. 102, No. 24, Dec. 15, 1998, pp. 38-42; Stephen Pociask "Structural Separation: Consequences for Michigan Consumers," TeleNomic Research, May 9, 2001; Stephen Pociask, "Structural Separation of BellSouth Telecommunications and Its Effects on Florida Consumers," TeleNomic Research, July 31, 2001; and Stephen Pociask, "Addition by Division: How Dividing-up Ameritech Indiana Would Add Costs and Harm Consumers," TeleNomic Research, May 14, 2001.

¹⁵ Randolph J. May and Larry F. Darby, FCC Comments of the Progress and Freedom Foundation, CC Docket No. 01-338, No. 96-98 and No. 98-147, p. 24.

¹⁶ Alfred Kahn, Timothy Tardiff, and Dennis Weisman, "The Telecommunications Act at Three Years: An Economic Evaluation of Its Implementation by the Federal Communications Commission," *Information Economics and Policy*, vol. 11, 1999, pp. 330-32.

¹⁷ The exception to this point is *intermodal* competition. Cable and wireless providers have now become formidable competitors for traditional telephone services. These providers do not require UNEs.



Summary

As the FCC rethinks its UNE rules, there is a possibility of positive regulatory changes, including limitations to unbundling and phasing out of UNE-P. However, the main problem that regulators have caused – namely, setting UNE prices too low – could remain unresolved. Resolving this problem will be paramount to bringing more intensive facilities competition, as well as increased consumer benefits, telecommunications investment and good paying jobs. These changes would boost economic growth and benefit consumers.

UNE was the Loneliest Blunder: From One Network to Many at the FCC

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The Federal Communications Commission's (FCC) proceeding on unbundled network elements will lay out the ground rules for the next generation of companies and networks. This is, clearly, a critical role. At the same time, the FCC is not, never has been, and cannot be in control of what telephony or broadband looks like two or ten years from now. But the FCC could and did spawn rules that pick who will win and who will lose. Technological innovation, investors, and consumer demand do more to shape the future, but regulators have an unfortunate penchant for handicapping the marketplace. Let's look at how some of these realities affect the unbundling proceeding.

The forces at work in telecommunications are as follows: There's no "killer app" for broadband. Bear Stearns recent reports point to the two services presently eroding the power of the former Bell networks (including AT&T), benignly neglected wireless and email. The resale or rebundling of old copper so minutely plotted by Reed Hundt's FCC has not taken center stage after all. All the FCC's tender care of MCI in the 1980's and 1990's could not save MCI/Worldcom. This is a paradox of markets; that legal regimes are everything—because no venture gets off the ground without a basic framework of rights—and nothing, because the forces that operate upon economic actors outside of the legal regime are so powerful and fast moving.

One implication of this is that the FCC faces harder problems in the unbundling proceeding than usually acknowledged. The common view in the press and on The Hill is that the issue of telephone competition is a question of the Few (the monopoly local phone companies) versus the Many (competing local exchange carriers), Big versus Little, Monopoly versus Competition. On this view, the FCC faces a simple political force—the incumbent local phone companies' influence. The FCC need only figure out what result is likely to be pleasing to the many to do the right thing; that is, to perpetuate extensive unbundling to benefit those CLECs that have not built out their own networks.

But anyone with a deeper grasp of economics understands that it is not so simple. A realistic grasp of economic forces at work beyond the FCC will push the agency in the direction of scaling back unbundling for voice and avoiding it for broadband.

- Wireless and cable technology means that the spread of competition in business and residential markets, from broadband to voice, need not rely so much on old copper loops.
- Uncertainties of consumer demand, especially for broadband, mean that investors will need more reward to take the risk.
- Regulation holding down prices in residential areas helps explain the slower expansion of CLECs here as much as (or more than) difficulties with ILECs.

For those in the press or legislature with little time to grapple with the perplexities of Alfred Kahn's footnotes, here is a red flag that there is more to it than Big versus Little: Observers with little reason to butter up local phone companies are calling for unbundling to be scaled back. These observers include companies like Corning and the "High-Tech" Broadband Coalition that includes Intel. They want broadband, and they argue that misplaced unbundling can do more harm than good by discouraging investment in new networks. Corning sponsored a detailed study showing that more than 80 percent of incumbent local phone companies' potential investment in DSL will be unprofitable if unbundled and made available to competitors at discounted prices. The High-Tech Broadband Coalition also calls for DSL to be held out of the unbundling regime.

The concern with unbundling can be expressed in a number of ways, all getting at the same point. Some say that the FCC's generosity in unbundling will delay facilities-based competition. That is, neither the incumbent local phone companies nor newcomers will have much reason to invest in new networks. In other words, the FCC should focus on giving companies reason to build in the future, as much as giving them the means to provide service in the present. One might also call this a dynamic rather than a static concept of competition. It is all a way of saying that the FCC needs to pay attention to forces like investment incentives and demand.

Terms like "facilities-based" and invisible forces don't make good press. The arguments and the data are hard to simplify into sound bites. But it is all a reflection of the old dispute between advocates of markets and advocates of government intervention. Is more wealth created by taking stuff from the haves and giving it to the have-nots? Or is more wealth created by making sure that both haves and have-nots have a reason to create it by letting them keep their own gains? This age-old division explains why seemingly technical issues like the fairness of TELRIC pricing have become so politicized.

The FCC's Notice in the Triennial Review and casual statements of the Commissioners suggest that the FCC is ready to address some of the hard economic questions here. And they should now have the reams of data and commentary they need to figure out what is really going on. The D.C. Circuit has told them that simply unbundling every network element that might cost more for a CLEC than an ILEC was not the right legal answer, aligning the law with sensible economics. They have every tool they need to play a leadership role, even if the outcome is not popular in every quarter.

This is not a comfortable position for the FCC to be in. The element of discomfort stems from the fact that once again the FCC's rules will indirectly and partially determine winners and losers, as any set of ground rules will if put in place late in the game. (And the agency is definitely late to the game). This time, their action can replace regulatory-favoritism with fair, consumer-friendly market forces. Losers will react as if the FCC had targeted them directly. If the FCC does the right thing, the hard thing, it will not be pretty. But when has good economics ever been pretty?