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AN EXPERT'S VIEW

Policy Wonk Speaks Out About Need For 'Real' Telecom Reform

'The Telecom Act Was Never About The Deregulation Of Incumbents'

The various entities involved in the ongoing multi-billion dollar telecom debate have been fighting with each other for so long that it seems like everybody in Washington has forgotten what the original fight was all about in the first place, observes Lawrence Spiwak, president of the Washington, D.C.-based Phoenix Center for Advanced Legal and Economic Public Policy Studies.

Spiwak, an internationally recognized authority on legal and economic issues affecting the telecommunications industry, is a former senior attorney with the FCC's now defunct Competition Division. He frequently is asked to speak before — and provide counsel to — industry business leaders and domestic and foreign government officials.

"Now that the D.C. Circuit has eviscerated the FCC's unbundling rules and there are increasing calls on Capitol Hill for a complete rewrite of the Telecommunications Act of 1996, perhaps we need to jog our collective recollections," Spiwak advises. "The core purpose of the 1996 Act was *never* fundamentally about the deregulation of incumbents or to encourage incumbent investments *per se* — although certainly an intended eventual consequence — but, as the Supreme Court observed, to 'reorganize markets by rendering regulated utilities' monopolies vulnerable to interlopers.'"

The way Spiwak sees it, if new capital is ever going to start flowing to the competitive local exchange carrier (CLEC) industry, then it is time for policymakers to refocus the debate onto the still

unresolved goal of the 1996 Act: how to make entry economically attractive so as to reorganize the market away from one dominated by monopoly incumbents to one characterized by competition.

Economics Of The Last Mile

"A basic maxim of business is that entry must be profitable," Spiwak says. Although capital is skeptical about the telecom industry (particularly in light of the lessons learned when the 1990's telecom bubble burst), funds can always be raised if a value proposition is established. "The big question, therefore, is whether new competitive entrants can create such a value proposition in light of recent developments," he says "After all, as the old saying goes: If you owe the bank a million dollars, then you can't sleep at night. But if you owe the bank $500 million, then *they* can't sleep at night."

Having learned its lesson in the 1990's, Wall Street now understands that telecom is an extremely expensive business and that telecom investment will require the commitment of significant sunk costs, notes Spiwak. Moreover, Wall Street also now understands that not all of these sunk costs are related to capital expenditure (cap-ex) requirements. Firms have to commit an average $2 of non-plant costs for every $1 of plant costs.

The issue isn't cap-ex requirements per se, but on the overall amount of risk investors must accept over their entire sunk (plant and non-plant) investment, he says. "The burden on potential entrants of having to raise and invest the huge sunk costs required to participate in the 'last mile' cannot be underestimated."

First, due to the inherently high sunk costs required to enter, firms will need to achieve scale economies quickly — approximately a 35-40 percent market share, says Spiwak. "Unless investors are comfortable that the venture will have sufficient customers that can produce a large enough revenue stream to service the money and/or provide a rapid exit strategy, capital for new 'last mile' network deployment will remain scarce," he says.

Just as important, because the incumbent's plant is already sunk and it is enjoying monopoly rents, the incumbent will always seek to sabotage new entrants' efforts in order to protect its own position, Spiwak contends. If investors perceive that regulators are allowing the incumbent monopolists to quash new entrants at will, however, then capital for new competitive "last mile" network deployment will be in short supply, he says.

A Pro-Entry/Pro-Investment Policy

Given these economic fundamentals, Congress could have chosen several different policy options in drafting the 1996 Act in order to encourage new competitive entry.

In Spiwak's view, the incumbent Bell monopolists would have preferred that Congress simply deregulate and allow them back into long distance without much burden. The Bells' rationale behind this argument has not changed in eight years: That is, policymakers need not worry about the incumbents' market power (i.e., the ability to raise prices and restrict output) for wireline services because with new technology, entry will be so easy that "intermodal" competition from other distribution platforms (i.e., wireless, cable, powerline, WiFi, etc.), will ensure the survival of telecom competition, Spiwak says.

"As noted by both the Supreme Court and empirical analysis, however, so-called intermodal competition has been more vision than reality and has yet to demonstrate a significant impact on the incumbent's competitive position or its strategic behavior," he adds.

"In contrast, the CLECs would have preferred that Congress continue the original AT&T divestiture process and force the Bells to structurally separate their network from their marketing operations. The theory behind this paradigm is that by eliminating the inherent conflict involved in allowing the Bells to be both wholesale supplier and retail competitor, the entity controlling the last-mile plant would no longer have any incentive to discriminate against new entrants seeking access to elements of their network. Instead, this entity would seek to maximize sales on a non-discriminatory basis."

As economically prudent a policy as this might have been, it was a political non-starter that died on the vine without much consideration, Spiwak notes. Instead, Congress went for the middle ground. In exchange for allowing the Bells to re-enter the long-distance segment of the market, the incumbent Bell monopolists had to make available to rivals unbundled elements of their network on a wholesale basis at just and reasonable rates. The idea behind unbundling is straightforward. Because entry barriers into the local access market are so high, unbundling — a weak form of divestiture, Spiwak says — seeks to "leapfrog" those barriers in order to accelerate the pace of competition. In its simplest form, unbundling is supposed to lead to new facilities-based competition by enabling new entrants to enter a very costly business, develop a customer base and then build-out as conditions warrant, argues Spiwak.

Was Congress' unbundling paradigm starting to work? Apparently so.

With nearly 19 million consumers using a service delivered by a rival by means of the unbundled network element platform, the requisite new "non-incumbent demand" required for new network investment in the "last mile" is finally starting to take hold, notes Spiwak.

"Equally as important, other societal benefits are starting to emerge such as more investment from incumbent and entrants alike, more jobs, and significant gains to U.S. consumer welfare," he says. "But unbundling has not yet achieved the second important need — a vibrant wholesale market. We appear to be on the cusp of achieving the sufficient amount of new non-incumbent demand required to warrant the investment in new 'last mile' network deployment, but a premature end to unbundling would make sure that this critical second stage of market evolution does not take hold."

"While private negotiations should be encouraged and … we should all hope for the best possible outcome, we also should be under no illusions that 45 days of commercial negotiations will somehow make 60 years of structural problems of the 'last mile' go away."

Lawrence Spiwak
President,
Phoenix Center for Advanced Legal and Economic Public Policy Studies

A Bucket of Cold Water

Unfortunately, the D.C. Circuit's evisceration of the FCC's unbundling rules has thrown a bucket of cold water on the CLEC's already difficult task of attempting to raise additional capital, says Spiwak.

"Given the significant analytical flaws in the decision, combined with the obvious cataclysmic effect the decision will have on the market if left to stand, the logical thing to do would be for the Commission to seek *certiorari* of *USTA II* with the Supreme Court." (*USTA II* refers to the D.C. Circuit's March 3 decision vacating key portions of the FCC's Triennial Review Order, including that part of the TRO that empowers state commissions to set wholesale rates for unbundled network elements, or UNEs.)

Rather than immediately seek certification of the *USTA II* case for review by the Supreme Court, the FCC has decided to try something radical, Spiwak notes: "In a unanimous letter to all of the major parties in the fight, the FCC asked all carriers to 'engage in a period of good faith negotiations to arrive at commercially acceptable arrangements for the availability of unbundled network elements.' In exchange for coming to the table, the FCC stated that it would petition the D.C. Circuit for a 45-day extension of the stay of its decision vacating the Commission's unbundling rules as well as request the Solicitor General to seek a comparable extension of the deadline for filing a petition for *certiorar*i."

Spiwak says that on the surface, this approach seems like a wise and prudent idea.

"After all, assuming that noted economist Oliver Williamson is correct in his argument that people are driven by 'bounded rationality,' private contracts should, in theory, be a far more efficient mechanism of allocating resources than government-imposed mandates. Equally as important, given the huge stakes involved, it would be political corporate suicide to refuse publicly to participate in the FCC's unanimous request, much less criticize the process," he says.

Yet, because the very foundation of these "commercial" negotiations is the result of political pressure, "we should not be afraid to discuss openly the policy implications of the FCC's approach," Spiwak says.

"While private negotiations should be encouraged and … we should all hope for the best possible outcome, we also should be under no illusions that 45 days of commercial negotiations will somehow make 60 years of structural problems of the 'last mile' go away," he says. Indeed, as of press time (April 27), only two CLECs (Sage Telecom and Covad) have managed to negotiate deals with incumbents (SBC and Qwest, respectively) on terms not fully understood by the market (primarily because the parties involved will not disclose them).

Even if the divergent parties in the dispute produce some short-term results via "voluntary" bi-lateral negotiations, absent appeal to the Supreme Court, "we cannot ignore the fact that *USTA II* — restricting access not only to unbundled network elements but also to shared transport and Enhanced Extended Links or EELs (two inputs of key importance not only to the wireline industry but to the wireless industry as well) — may still be on the books when these contracts expire," Spiwak contends.

"Accordingly, no matter how you slice it, *USTA II* spreads a dark specter over the competitive telephone industry's ability to attract new capital. And, until *USTA II* is removed either via *certiorari* or by new legislation, we should not expect otherwise," he says.