REMEMBERING WHAT THE FIGHT IS ABOUT

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Like the “100 Years War”, the various parties to the multi-billion dollar telecoms debate have been battling each other for so long that it seems like everybody in Washington has forgotten what the original fight was all about in the first instance.

Well, 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: the core purpose of the 1996 Act was never fundamentally about the de-regulation 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.”

If new capital is ever going to start to reflow to the telecoms CLEC industry, then it is high time for policymakers to refocus the debate back onto the still unresolved goal of the 1996 Act: how do we make entry economically attractive so as to allow us to “reorganize” the market so that we can move from by “one” (monopoly) to a market characterized by “many” (competition)?

Understanding the Economics of the “Last Mile”:

A basic maxim of business is that entry must be profitable – *i.e.*, “The Money” wants to see a rapid return of and on investment. Although capital is skeptical about the telecoms industry (particularly in light of the lessons learned when the 1990’s 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. (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.)

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Having learned their lessons in the 1990’s, Wall Street now understands that telecoms is an extremely expensive business and that telecoms investment will require the commitment of significant sunk costs. Moreover, Wall Street also now understands that not all of these sunk costs are related to cap-ex requirements. Firms have to commit an average $2 of non-plant costs (*e.g.*, billing, advertising, maintenance, regulatory fees, etc.) for every $1 of plant costs. Thus, the focus on “facilities-based” investment is a shibboleth: to “The Money”, the issue isn’t cap-ex requirements *per se*, but on the overall amount of risk “The Money” must accept over
their entire sunk (plant and non-plant) investment.\textsuperscript{4}

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% market share.\textsuperscript{5} 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.\textsuperscript{6}

Just as important, because the incumbent’s plant is already sunk and they are enjoying monopoly rents, the incumbents will always seek to sabotage new entrants’ efforts in order to protect their incumbent positions.\textsuperscript{7} If “The Money” perceives 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.

Developing a Pro-Entry/Pro-Investment Policy: Why Choose Unbundling?

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

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The incumbent Bell monopolist would have preferred that Congress simply de-regulate 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 (\textit{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 (\textit{i.e.}, wireless, cable, powerline, WiFi, etc) will ensure that Adam Smith’s invisible hand would thrash Ivan, Duane, Ed and Dick up-side their respective heads.\textsuperscript{8} 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 incumbents’ competitive position or its strategic behavior.\textsuperscript{9}

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 has been it was a political non-starter that died on the vine without much consideration.\textsuperscript{10}

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 – \textit{i.e.}, a weak form of divestiture – 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. Such a strategy is often referred to as a “smart-build” approach. This is precisely what the FCC did in its 1980 MTS/WATS Resale Decision to great success for the U.S. long-distance market.\(^\text{11}\)

Unfortunately, however, given the huge sunk costs and risks associated with constructing a new, alternative residential access network, many firms will not (or cannot) afford the “smart-build” approach. (The proverbial “build it and they will come” proved successful in Hollywood, but not for CLECs.) As PHOENIX CENTER POLICY PAPER NO. 12 therefore explained, unbundling is critical to developing and aggregating sufficient non-incumbent demand among many firms for new network-based facility investment.

That is to say, if a 40% market share is required to justify the construction of a new “last mile” access network, then who says one firm has to provide all 40%? Instead, if unbundling can facilitate 40 firms having 1% of the market each; 20 firms having 2% each, 10 firms having 4% each, etc., then a non-affiliated third party wholesaler can enter and consolidate (or aggregate) this new non-incumbent demand for network elements dispersed among the various firms who currently purchase UNEs from the incumbent (much like building a shopping center with your anchor tenants already secured). In so doing, network-based entry occurs both in the form of new alternative network construction, but also in terms of new technology investment (e.g., interconnecting a sophisticated database to the incumbents’ AIN to permit advanced managed-IP products and services). Thus, by creating a vibrant wholesale market, while the number of networks may be few, the number of providers may be many – an arrangement that is most compatible with the underlying economics of the telecommunications industry.\(^\text{12}\)

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. Equally as important, other societal benefits are starting to emerge such as more investment (from incumbent and entrants alike)\(^\text{13}\), more jobs\(^\text{14}\), and significant gains to U.S. consumer welfare.\(^\text{15}\) 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.

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**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 CLEC’s already difficult task of attempting to raise additional capital. 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.
The FCC, however, decided to try something radical: In a unanimous letter to all of the major parties to 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 certiorari.16

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”,17 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.

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. That is to say, while private negotiations should be encouraged and that 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 sixty years of structural problems of the “last mile” go away. Indeed, the fact that at the time of this writing just two CLECs (Sage Telecom and Covad) have negotiated deals with incumbents (SBC and Qwest respectively) on terms not fully understood by the market (primarily because the parties will not disclose them) does not a fortiori mean that an efficient outcome has been reached and that there is a vibrant “last mile” wholesale market that will constrain the incumbents’ market power.

But wait, there’s more: even if we assume that the divergent parties to the dispute are able to 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 but to the wireless industry as well) – may still be on the books when these contracts expire.

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.

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Moving Forward

As noted above, there much talk in Washington about revisiting and fundamentally rewriting the 1996 Act. Naturally, each side will present widely divergent views of what’s right and what’s wrong and needs to be changed. On one hand, one could accept the view of incoming House Commerce Committee Joe Barton that legislative change is required because “the current regulatory scheme is unfair” to the Bells.18 Alternatively, we could accept the argument of Chris Murray, legislative director for Consumers Union in Washington, D.C. that reform is needed, not “because the law didn't
contemplate new technology; it needs to be rewritten to provide consumers more choice in the cable and telecom services.”

Either way, if policymakers on both sides of the aisle truly want to “encourage the deployment on a reasonable and timely basis of advanced telecommunications capability to all Americans” by utilizing various regulatory tools that “promote competition in the local telecommunications market or other regulating methods that remove barriers to infrastructure investment”, then policymakers must account for the consequences of their actions on the entry decisions of new firms rather than on incumbents.

Supreme Court Justice Felix Frankfurter warned us over fifty years ago that we cannot view telecommunications competition in an “abstract, sterile way.” Accordingly, for those truly interested in responsible public policy making to maximize U.S. consumer welfare, then the choice is simple: either return to economic first principles in order to enable competition or just admit capture by the incumbents and return us to monopoly.
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1 Verizon v. FCC, 535 U.S. 467, 489; 122 S.Ct. 1646, 1661 (2002). Even President Bush agrees. Indeed, President Bush has not argued for improving the investment incentives of a single sector of the industry (i.e., the Bell incumbents), but from new entrants. To wit, President Bush announced just last month that as part of a national broadband goal for the United States,

[W]e ought to make sure as soon as possible ... [that] consumers have got plenty of choices when it comes to purchasing [a] broadband carrier. See, the more choices there are, the more the price will go down. And the more the price goes down, the more users there will be. And the more users there will be, the more likely it is America will stay on the competitive edge of world trade.


2 Thus, for the D.C. Circuit to make such a ridiculous statement that, for example, there “appears to be no suggestion that mass market switches exhibit declining average costs in the relevant markets, or even that switches entail large sunk costs” is just plain ignorant. United States Telecom Association v. FCC, 359 F.3rd 554, 569 (D.C. Cir. 2004). Heck, even the Bells concede that “switches are a sunk investment”. BELLSOUTH, SBC, QWEST AND VERIZON UNE FACT REPORT (April 2002) at B-1.


4 See, e.g., 19 November 2003 Testimony of John Thorne, Executive Vice President and Deputy General Counsel – Verizon, before the House Judiciary Committee (“wholesale [margin] that’s available to UNE loops is thin”); 9 September 2003 Remarks of Ronald Dykes, Chief Financial Officer – BellSouth at the Morgan Stanley 8th Annual Global Media & Communications Conference (“There are a lot of regulatory factors floating around, but it wouldn’t take but maybe one of these to have a pretty fundamental change in this environment, given the - given the thinness of margins in UNE-P provisioning”).

5 PHOENIX CENTER POLICY PAPER NO. 12, supra n. 3.

6 These economics hold true for incumbent and new entrant “Fiber to the Home” or “FTTH” deployment alike (although the incumbent certainly has a first mover advantage) – i.e., because of the huge sunk costs required for entry (discussed supra), BOC deployment of new fiber to the home (much less the neighborhood) is a very long way off. As an excellent expose by telecoms journalist Jonathan Krim in the WASHINGTON POST recently noted:

[M]any telephony experts, financial analysts and some phone company officials say that even if the former Bell telephone companies get the regulatory relief they seek, fiber to people’s homes will remain a far-off dream. Not only does stringing fiber to the home remain enormously expensive, but advances in technology allow significantly faster connection speeds to be squeezed out of the country’s 1.5 billion miles of existing copper lines.

As such, it is highly unlikely that consumers can expect their local BOC to deploy new fiber to their home (along with the extremely expensive optronics to light this fiber) anytime soon. See, Jonathan Krim, Copper Lines Regaining Luster, The WASHINGTON POST (07 February 2003) (emphasis supplied). See also Mark Wigfield, Martin Chides Bells for Shirking New Investment in Broadband Dow Jones Newswires (21 February 2003) (reporting that “the Bells said they would likely not increase their investment in broadband even though the FCC deregulated those services.”); T.A. Badger, DirecTV Could Add to SBC’s Challenges, Associated Press (12 February 2003) (rather than proceed with its long-announced plan (“Project Pronto”) to deploy fiber to every home in its vast region, SBC is attempting to purchase DirecTV, the nation’s No. 2 pay-television company, even though “many telecom analysts say purchasing [DirecTV] ... would dilute SBC’s earnings and would not create synergies with the company’s existing phone-oriented businesses.”).
NOTES CONTINUED:

7 PHOENIX CENTER POLICY PAPER NO. 12, supra n. 3.

8 C.f., Mark Wigfield, FCC’s Abernathy: Court Won’t Affect Phone Service Pricing, DOW JONES NEWSWIRE (18 March 2004) (According to FCC Commissioner Kathleen Abernathy, “What really drives [fixed-line] pricing is the competition from wireless”).

9 PHOENIX CENTER POLICY BULLETIN No. 10: Fixed-Mobile “Intermodal” Competition in Telecommunications: Fact or Fiction? (31 March 2004) (http://www.phoenix-center.org/PolicyBulletin/PCPB10Final.pdf); see also Verizon, supra n. 1 at 1677, n. 35 (“the use of wireless technology in local-exchange markets is negligible at present”).

10 One of the primary arguments that policymakers accepted in supporting this policy choice was that a structurally separated “LoopCo” would be economically unsustainable. (See, e.g., Regulatory Overkill: Pennsylvania’s Proposal to Breakup Bell Atlantic by Jeffrey A. Eisenach, Randolph J. May, and Charles A. Eldering, Progress & Freedom Foundation (December 16, 1999) (http://www.pff.org/papucreport.htm).) The economics indicate the opposite conclusion, however. First, the LoopCo’s costs are already sunk, and it has already achieved the necessary scale economies necessary to be successful. As such, it will already be established in a market capable if sustaining only a few firms. Second, assuming arguendo that there are no other local access facilities (or even a few), it is highly likely that regulators will still impose some sort of price regulation on the LoopCo. As such, it is unclear how a LoopCo would be economically unviable when its operational costs are guaranteed by regulation. Finally, it may turn out that the LoopCo would exceed its regulatory rate of return through the market because divestiture has removed its incentive to discriminate and replaced it instead with an incentive to sell as much of its product – i.e., local access – to as many potential buyers it could find. Indeed, if a LoopCo is really such an inefficient business proposition, then why did British Telecom reject offers of $11.4 billion and $25.7 billion respectively for its local access networks from firms who realized the benefit of breaking out the value of BT’s assets via a LoopCo? See Dan Roberts, British Telecom Dismisses £8bn Local Line Bid, FINANCIAL TIMES (July 29 2001) (quoting potential purchaser as believing that “BT has ignored the potential of its local loop because any ADSL services provided by rival operators compete with its own retail division.”); Andrew Ward, WestLB in $25.7bn Offer for BT Fixed-line Network, FINANCIAL TIMES (August 5 2001).


12 For example, the creation of a vibrant “mobile virtual network operator” or “MVNO” market is nonetheless well underway in the rest of the world as evidenced by the fact that MVNOs such as Virgin Mobile, Sense Communications and the Financial Times Group – i.e., firms that are essentially “marketing machines” – are all making significant headway in numerous markets in Europe, Asia and Australia. See, e.g., Telecom NZ’s AAPT Looks for Australia MVNO Deals, TOTAL TELECOM (17 September 2001); Virgin plans US$550m Asian Spend, Sees HK Partner Soon, TOTAL TELECOM (12 June 2001) (U.K.-based Virgin Group plans to spend (US) $550 million on expanding its mobile virtual network operations in 10 Asian regions over the next three to five years according to Ross Cormack, chief executive of Virgin Mobile (Asia)); Ray Le Maistre, Operators: MVNOs - Not All Virgins, ROAM (04 June 2001); George Malim, COR Boosts the Power of Smaller MVNOs, TOTAL TELECOM (21 May 2001); Annie Turner, Mobile Virtual Network Operators: Taking Root, NEW CARRIER (30 April 2001); Anne Young, FT and The Carphone Warehouse Form MVNO Deal with Cellnet TOTAL TELECOM (05 March 2001); Joanne Taaffe, Feature: Mobile Virtual Network Operators - Marking Out Their Territory, Communications Week International (05 March 2001); Anne Young, MVNOs: a Market Essential or an Operator’s Bete Noire? TOTAL TELECOM (22 February 2001); Gerard O’Dwyer, Norwegian MVNO Sees Sense in Nordic Expansion, TOTAL TELECOM (06 February 2001); Emma McClune, 3G Owners Awash with Virtual Partner Offers, Communications Week International (15 January 2001).

Equally as important, an MVNO market is beginning to get underway here in the United States. See, e.g., Paul Taylor, AT&T Considers New Wireless Service, FINANCIAL TIMES (26 February 2004); Bruce Meyerson, Two Cell Phone Companies Going National, ASSOCIATED PRESS (29 February 2004) (reporting that in addition to AT&T’s announcement that it was going to become an MVNO, Qwest Communications is expanding its regional cell service with the introduction of national coverage and calling plans provided over Sprint Corp.’s wireless network under the Qwest Wireless brand); Bruce Christian, Wanted: Channels for Wireless Wholesalers Look to Resellers for Distribution Help, Phone+ (March 2001); Virgin Teams up with Sprint to Hit U.S., Reuters (05 October 2001). In fact, according to a just published Wall Street Journal article, Sprint reported strong wireless subscriber growth, “driven in large part by its increasing its reselling, or wholesale, agreements with carriers” – specifically, “Sprint reported that it added 414,000 wireless customers. But even more – 420,000 – came from its wholesale
agreements, mostly with Virgin Mobile USA LLC, which targets the youth market. Sprint now has 16.3 million direct wireless customers, three million affiliate customers and two million wholesale subscribers.” Jesse Drucker, AT&T Wireless Reports Big Drop in Subscribers, Wall Street Journal (20 April 2004).


15 Phoenix Center Policy Bulletin No 8, The $10 Billion Benefit of Unbundling: Consumer Surplus Gains from Competitive Pricing Innovations (27 January 2004) (available at http://www.phoenix-center.org/PolicyBulletin/PCPB8Final.pdf) (empirically demonstrating that the new “all distance”/“all you can eat” competition produced by the market-opening unbundling provisions of the Telecommunications Act of 1996 creates approximately $10 billion per year in consumer welfare gains and, for those American households that have switched to these all-distance plans are, on average, a savings of approximately $429 every year – more than a dollar a day); see also CompTel/Ascent March 15, 2004 Press Release: Consumers Spent $11 Billion Less in 2003 Than Before Competition: Data Shows 23 Percent Decline in Home Phone Bills (available at http://www.comptelascent.org/news/recent-news/031504.html).

16 The D.C. Circuit granted this extension on 14 April, thus pushing back the deadline until 15 June 2004. (D.C. Circuit order per curiam, Order No. 00-1012).


18 Laura Litvan, Joe Barton May Succeed Tauzin as House Chairman, BLOOMBERG NEWS (4 February 2004).

19 Lawmakers Sending Signals of Soon-To-Come Telecom Reform, TELECOMWEB (12 March 2004).
