PERSPECTIVES

PHOENIX CENTER FOR ADVANCED LEGAL & ECONOMIC PUBLIC POLICY STUDIES

The Creeping Tide of the Gathering Storm

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De-regulation is always a tricky business.

On the one hand, the whole purpose of economic regulation in the first instance is to prevent dominant incumbent firms from exercising their considerable market power. Indeed, the incumbent Bell telephone companies' market power did not derive from a "superior product, business acumen or historical accident"[1] but from very deliberate government policies designed to promote and protect incumbent monopolies in exchange for ubiquitous service.

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On the other hand, because government intervention into the market imposes costs on new entrants and incumbents alike and can be, particularly with regard to price regulation, an "inexact science",[2] we always need to make sure that the costs of regulation do not exceed the public interest benefits.[3]

While often a difficult balance, throughout the history of the telecommunications industry policymakers have prudently opted to see solid evidence of workable competition before deregulating incumbents (declaring AT&T to be a non-dominant carrier for long distance service being the most prominent example[4]). In stark contrast, where the FCC has opted to wing it – such as in the case of providing the Bells with pricing flexibility for Special Access services – the results have been a disaster.[5] After all, as the old maxim goes, competition policy should focus on "probabilities" and not upon "ephemeral possibilities."[6]

While it is very important for policy makers to take a dynamic approach to telecoms,[7] it unfortunately appears that many policymakers recently have used anecdotal evidence of intermodal competition to blur deliberately the line between "probability" and "ephemeral possibility" in order to justify the increasing deregulation of the incumbent Bell monopolists.[8] Indeed, as demonstrated repeatedly, both product differentiation (most notably quality of service issues[9]) and market structure (*e.g.*, common dominant incumbent ownership in both the wireline and wireless markets or the potential for undue discrimination against third-party VoIP providers by dominant broadband facility owners[10]) strongly work against effective

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substitution for last mile access. When pressed, even the Bells concede these facts.[11] Equally as important, competition from nascent technologies such as Wi-Max and Broadband Powerline are still not quite ready for prime-time and business cases have yet to be developed to make entry economically viable.[12] Despite the FCC's best rhetorical efforts, therefore, they simply cannot "assume away" market power[13] in the naïve hope that de-regulation will spur new BOC fiber deployment.[14] When they do, then end-users – both large and small – are in real danger of losing the competitive benefits gained over the last twenty years when the FCC issues its revised unbundling rules this December.

The First Wave: The Elimination of Competition in the Residential Market

Say what you will about the 1996 Act, it worked. Empirical research proves conclusively that consumers are saving more than $10 billion annually on phone service because of competition made possible by the Act. Employment levels in the traditional wireline sector of telecom services remain 17 percent above historical trends. Net investment by the incumbent carriers has increased by about 6.4 percent per year. And, surprise, surprise, new research backs up the obvious proposition that where the rates for unbundled network elements are lower, the deployment of new and much-desired broadband services is higher.[15]

Yet, it is no real shocker that when the D.C. Circuit in *USTA II* rolled back the network sharing requirements that provided competitive carriers with unbundled network access to last mile facilities at cost-based rates, competition for new customers in the local residential and mass market telecoms marketplace collapsed. Carriers as large as AT&T and as small as Hoosier Telecom, for example, have abandoned marketing in the consumer space to concentrate on serving business customers. Thus, even if residential rates increase by only $1 a month, people tend to forget that when you multiply $1 by 180 million telephone lines by 12 months, you end up with a naked rent transfer to the Bells of more than $2.2 billion per year – real money by anyone's standards, but who's counting?

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The Creeping Tide: Enterprise Business Customers

The current blind movement of basing policy on "ephemeral possibilities" rather than on "probabilities", particularly without regard to the impact of these flawed policies on the ability of competitors to enter the marketplace, signals a threat to competition in the business marketplace as well.

Of particular concern is a possible FCC decision to eliminate UNE access to high capacity DS1 and DS3 pipes when it issues its final unbundling rules this December. Combined

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with the flawed decision five years ago to provide the Bells with pricing flexibility for Special Access lines that serve high volume business customers,[16] the demise of UNE access for DS1s and DS3s can only push prices up and competition down in the Enterprise sector.

Significantly, business customers actually have fewer choices than residential customers for last mile access – *e.g.,* wireless or VoIP over cable broadband are not close substitutes (much less operational substitutes) for a DS1 or DS3 trunk. If the FCC eliminates access to unbundled DS1s and DS3s when it issues its final unbundling rules, then Enterprise users must understand that because of the FCC's flawed pricing flexibility paradigm and because the prospects for new entry for special access services are bleak,[17] they are about to be squeezed even harder. With the wrong FCC decisions, Enterprise users will continue to be forced to pay rates far in excess of costs (*i.e.,* monopoly rents) and also to accept increasingly onerous use restrictions on how they may utilize these pipes.[18] As the textbook definition of a monopolist is the ability to raise prices and restrict output, what more need be said?

Indeed, we are not talking about a buck or two a month increases as we are in residential; in the Enterprise sector we are talking about monthly increases in the thousands if not millions of dollars. As advanced and cost-effective IT is a major component of a large Enterprise user's ability to compete effectively and manage their bottom line, this issue should be of prime importance to any Chief Information Officer or Chief Technology Officer. (In fact, it is astonishing major industry trade associations such as the US Chamber of Commerce are permitting their policy agendas to be co-opted by the Bells rather than advancing the interests of the rest of its dues-paying members.[19])

The Gathering Storm

Like it or not, there is a gathering storm on the telecommunications horizon. The Bell telephone monopolies are continuing a de-regulatory march across the country that threatens to set back nearly twenty years of bi-partisan public policy that promotes competition. Competitive carriers are rapidly exiting the market, vertical integration is becoming ensconced, and choices are diminishing. If end-users – both large and small – don't develop a "constituency for competition" soon and let policymakers know that these issues are important to their bottom-lines, policymakers will continue to ignore telecoms users and the Bells' regulatory capture of the political process will proceed undiminished. And when the knock on the door comes to announce that the only choice for phone services comes in basic black, they can't say they weren't warned.

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1 *See, e.g., Verizon Communications v. Trinko*, 124 S.Ct. 872, 878-79 (2004).

2 *Illinois Cities of Bethany v. FERC*, 670 F.2nd 187, 191 (D.C. Cir. 1981).

3 *In re Motion of AT&T Corp. to Be Reclassified as a Non-Dominant Carrier*, FCC 95-427, 11 FCC Rcd. 3271 (1995) at ¶ 32 ("When the economic costs of regulation exceed the public interest benefits, the Commission should reconsider the validity of continuing to impose such regulation on the market.")

4 *Id.*

5 *In re Access Charge Reform*, Fifth Report and Order and Further Notice of Proposed Rulemaking, ___ FCC Rcd ___, FCC 99-206 (rel. 27 Aug. 1999)(*Pricing Flexibility Order*). For a thorough exegesis of this topic, *see* George Ford and Lawrence J. Spiwak, *Set It and Forget It? Market Power and the Consequences of Premature Deregulation in Telecommunications Markets*, PHOENIX CENTER POLICY PAPER NO. 18 (July 2003) (http://www.phoenix-center.org/pcpp/PCPP18.pdf), *with updated version forthcoming in* NYU JOURNAL OF LAW & BUSINESS (Spring 2005).

6 *Brown Shoe v. United States*, 370 U.S. 294, 323 (1962); *United States v. FCC*, 652 F.2nd 72, 99 (D.C. Cir. 1980); *SBC v. FCC*, 56 F. 3rd 1484, 1494 (D.C. Cir. 1995) (the FCC's "responsibility is to deal with 'probabilities' not ephemeral possibilities'.")

7 *See, e.g.,* Walter G. Bolter et al., TELECOMMUNICATIONS POLICY FOR THE 1980'S: THE TRANSITION TO COMPETITION 360 (1984); *see also Turner Broadcasting System, Inc., v. FCC*, 117 S. Ct. 1174, 1189 (1997) (regulatory schemes concerning telecommunications have "special significance" because of the "inherent complexity and assessments about the likely interaction of industries undergoing rapid economic and technological change"); *Denver Area Educational Telecommunications Consortium, Inc., v. FCC*, 116 S. Ct. 2374, 2385 (1996) (The Court is "aware . . . of the changes taking place in the law, the technology, and the industrial structure, related to telecommunications, *see, e.g.,* Telecommunications Act of 1996 . . . ."); *Columbia Broadcasting, Inc v. Democratic National Committee*, 412 U.S. 94, 102, 93 S. Ct. 2080, 2086 (1973) ("The problems of regulation are rendered more difficult because the . . . industry is dynamic in terms of technological change"); *FCC v. Pottsville Broadcasting Co.*, 309 U.S. 134, 138 (1940) ("Communications Act is not designed primarily as a new code for the adjustment of conflicting private rights through adjudication. Rather it expresses a desire on the part of Congress to maintain, through appropriate administrative control, a grip on the dynamic aspects" of the telecommunications industry).

8 Perhaps no greater example of such specious decision-making can be found than in the FCC's recent decision forbear from enforcing the unbundling requirements of Section 271 of the Telecommunications Act of 1996 for all four Bell Operating Companies for fiber-to-the-home loops (FTTH loops), fiber-to-the-curb loops (FTTC loops), the packetized functionality of hybrid loops, and packet switching. *In re Petition for Forbearance of the Verizon Telephone Companies Pursuant to 47 U.S.C. § 160(c) et al.,* MEMORANDUM AND ORDER, FCC 04-254, ___ FCC Rcd __ (rel. 27 October 2004). There, the FCC openly admitted that even though they "expect intermodal competition to become increasingly robust, including providers using platforms such as satellite, power lines and fixed and mobile wireless . . . that will prevent the BOCs from engaging in unjust and unreasonable practices at any level of the broadband market" (¶ 29), "*we acknowledge that the question is not entirely susceptible to resolution with evidentiary proof, and a degree of informed prediction is required.*" (¶ 26 emphasis supplied). To his credit, FCC Commissioner Michael Copps hit it right on the nose with his scathing dissent:

> But broad rhetoric about the power of competition does not make it happen. And choosing to ignore the Commission's own data does not help the weak analytical structure on which this decision is built.
>
> The facts are clear. This Commission's most recent report on high-speed services shows that the residential and small business market is a duopoly. Our data show that new satellite and wireless technologies—exciting though they are—together serve only 1.3 percent of this market. Broadband over powerline does not yet even register. Yet the majority chooses to ignore the Commission's statistics, preferring instead sweeping rhetoric about regulatory relief and broadband competition.

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> One problem here is that the majority gets so carried away with its vision of the country's telecom future that they act like it is already here, that competition is everywhere flourishing, and that intermodal competition is already ubiquitous reality. But their cheerful blindness to stubborn market reality actually pushes farther into the future the kind of competitive telecom world they say they want.
>
> The lack of analysis in this proceeding—and in the Commission's approach to broadband generally—amounts to a regulatory policy of crossing our fingers and hoping competition will somehow magically burst forth.

[9] People want reliable and relatively cheap phone service. They don't want to go out into the market and make complex decisions (although they will do this for everything else from cars to TV sets); they just want to pick up the phone, get a tone, and dial. For this reason, many potential residential customers are still reluctant to give up their traditional fixed-line PSTN phone for VoIP. It's not that they lack of confidence in VoIP, but they aren't certain of their broadband providers' reliability.

[10] *See* Lawrence J. Spiwak, *Net Neutrality: Now More than Ever*, CNET NEWS.COM (27 July 2004) (http://www.phoenix-center.org/CNET27July2004.pdf).

[11] *See* PHOENIX CENTER POLICY BULLETIN NO. 10: *Fixed-Mobile "Intermodal" Competition in Telecommunications: Fact or Fiction?* (30 March 2004) and citations therein (http://www.phoenix-center.org/PolicyBulletin/PCPB10Final.pdf); PHOENIX CENTER POLICY BULLETIN NO. 11: *Higher Prices Expected from the Cingular/AT&T Wireless Merger* (26 May 2004) and citations therein (http://www.phoenix-center.org/PolicyBulletin/PCPB11Final.pdf).

[12] *See* Dissenting Statement of Commissioner Copps, *supra* n. 8; *see also* Peter J. Howe, *Utilities Take Pass On Offering Broadband*, THE BOSTON GLOBE (25 October 2004) (reporting that while the "nation's top telecommunications regulators are convinced that electric-power lines are finally ready to become a revolutionary new way for Americans to get high-speed Internet access, unleashing competition for cable and phone giants", the "the utility companies that would actually deploy the services remain overwhelmingly skeptical." In fact, the Globe reported that of the nearly 160 investor-owned utilities in the United States, only one – Cinergy Corp. in Cincinnati – has moved ahead with a significant commercial rollout, "so far attracting barely 1,500 subscribers" while the rest, even though there were dozens of trials, "took a pass on making a business venture of it."

[13] Another recent example of the Commission's Pollyannish "thousand broadband flowers blooming" approach to public policy can be found in their approval of the acquisition of AT&T Wireless by Cingular Wireless (a company jointly owned by SBC and Bell South). *In the matter of Applications of AT&T Wireless Services, Inc. and Cingular Wireless Corporation For Consent to Transfer Control of Licenses and Authorizations,* MEMORANDUM OPINION AND ORDER, FCC 04-255, ___ FCC Rcd ___ (rel. 26 October 2004). There, even though the Commission found that because "BellSouth and SBC derive such a significant portion of their revenues from their in-region wireline operations, these companies have an incentive to protect their wireline customer base from intermodal and intramodal competition" (¶ 237), that they had "insufficient information to determine the particular combination of anytime minutes and price points most desirable to mass market consumers that have either cut the cord or would consider cutting the cord" (¶ 240), that there remain qualitative differences between wireless and wireline services (¶ 247), that Cingular is unlikely to initiate its own wireless substitute offering post-acquisition in the SBC and BellSouth regions (¶ 245), and that substitution between wireline and wireless competition is currently "limited" (¶ 242) and will remain so "for the foreseeable future" (247), the FCC nonetheless held that because fixed-mobile intermodal competition "has the *potential* to be a substantial source of facilities-based competition in the future" (¶242 emphasis supplied) the merger would have no effect on fixed/mobile interconnection. As Commissioner Copps put it wryly in his dissent: "I guess this means we won't be hearing so much rhetoric in the future about the power of wireless as an intermodal competitor."

But there is more: Given the rapid vertical integration of the market by the Bells, non-Bell mobile carriers are also at risk of discriminatory conduct. *See, e.g.*, LEGG MASON RESEARCH, *After the Bell Trifecta: Telcos Stay on Offense*, Eye New Policy Moves 15 September 2004). As Commissioner Copps also pointed out in his dissent in the Cingular-AWE Order, non-discriminatory access to high capacity pipes are also at risk:

> In order for wireless competitors to ramp up to compete with the merged entity in such a situation, competitors will need to purchase inputs from a wireline carrier in the market at issue, unless they have excess capacity currently laying fallow. Even if they have excess capacity, they must rely on a wireline carrier to maintain their current service without raising prices. In particular, if special access or

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> interconnection is offered to an independent wireless carrier at higher rates or with less favorable terms or conditions compared with a Bell-affiliated wireless carrier, the independent carrier will find it extremely difficult to provide a competitive check on the affiliated carrier. If the incumbent wireline carrier controls the largest wireless carrier in a region, it has an incentive to provide superior special access and interconnection rates, terms, and conditions to its affiliate. That is because by crippling potential competitors it will enhance its affiliate's profits and thereby enhance its own profits.

[14] *See, e.g., Bell "Fiberprofitopia": Too Many Weak Links in the Chain of ROI Assumptions*, PRECURSOR RESEARCH (19 October 2004).

[15] *See, e.g.*, George S. Ford and Lawrence J. Spiwak, *The Positive Effects of Unbundling on Broadband Deployment*, PHOENIX CENTER POLICY PAPER NO. 19 (September 2004) (http://www.phoenix-center.org/pcpp/PCPP19Final.pdf); *see also* Phoenix Center research, *infra* n. 19; Kenneth Flamm, *The Role of Economics, Demographics, and State Policy in Broadband Competition: An Exploratory Study*, Presented at the Telecommunications Policy and Research Conference - Arlington, Virginia (October 2, 2004)(http://web.si.umich.edu/tprc/papers/2004/397/flammtprcrev2.pdf).

[16] *See supra* n. 5.

[17] *See Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers* (CC Docket No. 01-338), *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996* (CC Docket No. 96-98), and *Deployment of Wireline Services Offering Advanced Telecommunications Capability* (CC Docket No. 98-147), Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, FCC 03-36, ___ FCC Rcd ___ (rel. 21 August 2003)("*Triennial Review*") at ¶¶ 302-324, where the FCC goes into great detail about the various barriers to entry for new high-capacity loops.

[18] An excellent case study of how the Bells' asymmetrical bargain power sabotages new entry can be found in the FCC's efforts to have the various parties "engage in a period of good faith negotiations to arrive at commercially acceptable arrangements for the availability of unbundled network elements" such as switching immediately after the *USTA II* decision came down. http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-245631A1.pdf. Yet, rather than embrace various offers from CLECs who wanted to move away from UNE-P towards facilities-based competition, however, the Bells rejected these offers out of hand. *See, e.g., AT&T Proposes Limiting Phone Network Leasing*, REUTERS (29 April 2004). But why? Isn't having CLECs deploy their own switching equipment exactly what the Bells professed they wanted? Well, here's the real kicker: Press reports revealed that the Bells never wanted the CLECs to deploy their own switching equipment in the first instance. In fact, they tried to force the CLECs to use the BOCs' embedded facilities exclusively. Indeed, both SBC and Verizon are requiring that CLECs use their networks for nearly all of the CLECs' phone traffic, discouraging the CLECs from installing their own equipment and preventing them from leasing from other providers. As a result, the press reported that many talks with these incumbents died. James S. Granelli, *Bells Now Aim for Rivals to Use Gear,* LOS ANGELES TIMES (7 May 2004). For example, the WALL STREET JOURNAL reported that under the terms of SBC's proposal to Talk America (a small company in Reston, Va., that sells bundled local and long-distance services), SBC would require Talk America to send 90% or more of its phone traffic to SBC's network instead of using its own equipment and not enter similar agreements with rival phone networks. Anne Marie Squeo, *SBC Dispute Undermines Move Toward Local Phone Competition*, WALL STREET JOURNAL (6 May 2004). When push comes to shove, it seems the Bells preferred to keep CLECs' captive because they earn more on UNE-P than they would on UNE-L and, therefore, according to some Wall Street analysts, "appear firm in their opposition to any UNE-L strategy" LEGG MASON WASHINGTON TELECOM & MEDIA INSIDER, *FCC Phase Out of UNE-P Not so Simple* (14 June 2004) and, given past conduct, access to either unbundled high capacity loops or Special Access lines promises no better treatment.

[19] Indeed, the U.S. Chamber of Commerce recently commissioned a study (*Sending the Right Signals: Promoting Competition Through Telecommunications Reform*, available at http://www.uschamber.com/broadband/041006telecommstudy.htm) by several economists who simply regurgitated their previous testimony filed on behalf of the Verizon (as well as other testimony filed by the Bells) at the FCC in a collateral effort to discredit previous Phoenix Center research posted on our web page that examined the effect of the market-opening provisions of the 1996 Act on investment and employment. While the Phoenix Center, as a non-profit research institution, does not believe it appropriate to participate in regulatory proceedings, we believe it appropriate to consider formally these various comments as there is always the possibility that critical review, even when adversarial rather than academic in nature, may prove useful in improving our analyses or, in some cases, reveal trivial or substantial flaws that we may have inadvertently committed or overlooked. Moreover, such comments are also useful in providing direction for future

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research. When we did, not only did we find much of Drs. Hazlett *et al.'s* methodology to be significantly analytically flawed, when we corrected for these methodological errors and utilized the alternative approach suggested in the critiques, our original results actually *improved*. PHOENIX CENTER POLICY BULLETIN NO. 5, *Competition and Bell Company Investment in Telecommunications Plant: The Effects of UNE-P* (17 September 2003) (http://www.phoenix-center.org/PolicyBulletin/PolicyBulletin5.pdf); COMMENTS OF DRS. THOMAS HAZLETT (THE MANHATTAN INSTITUTE), ARTHUR HAVENNER (UNIV. CALIFORNIA - DAVIS), AND COLEMAN BAZELON (HHB I) TO PHOENIX CENTER POLICY BULLETIN NO. 5 (http://www.phoenix-center.org/PolicyBulletin/HazlettetalComments.pdf); R. CARTER HILL COMMENTS PHOENIX CENTER POLICY BULLETIN NO. 5 (http://www.phoenix-center.org/PolicyBulletin/HillComments.pdf); PHOENIX CENTER POLICY BULLETIN NO. 6: *UNE-P Drives Bell Investment - A Synthesis Model* (17 September 2003) (available at: http://www.phoenix-center.org/PolicyBulletin/PolicyBulletin6Final.pdf); FURTHER COMMENTS OF DRS. THOMAS HAZLETT (THE MANHATTAN INSTITUTE), ARTHUR HAVENNER (UNIV. CALIFORNIA - DAVIS), AND COLEMAN BAZELON (ANALYSIS GROUP) TO PHOENIX CENTER POLICY BULLETIN NO. 6 (HHB II) (http://www.phoenix-center.org/critiques/HHBII.pdf); A RESPONSE TO DRS. HAZLETT, HAVENNER AND BAZELON (http://www.phoenix-center.org/critiques/ReplytoHHBII.pdf); *see also* PHOENIX CENTER POLICY BULLETIN NO. 7: *The Positive Effects of Competition on Employment in the Telecommunications Industry* (15 October 2003)(http://www.phoenix-center.org/PolicyBulletin/PolicyBulletin7Final.pdf); COMMENTS OF ROBERT W. CRANDALL AND HAL J. SINGER (http://www.phoenix-center.org/critiques/CrandallSinger.pdf); A RESPONSE TO DRS. CRANDALL AND SINGER (29 January 2004) (http://www.phoenix-center.org/critiques/CrandallResponse.pdf).

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