

Attachment D

**Before the
Federal Communications Commission
Washington, D.C. 20554**

In the Matter of)	
)	
Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers)	CC Docket No. 01-338
)	
Implementation of the Local Competition Provisions in the Telecommunications Act of 1996)	CC Docket No. 96-98
)	
Deployment of Wireline Services Offering Advanced Telecommunications Capability)	CC Docket No. 98-147
)	

Reply Declaration of Howard A. Shelanski

I. Facilities-Based Competition Benefits Consumers and Refutes Claims of Competitive Impairment

1. The UNE Fact Report 2002, submitted in these proceedings by Verizon, Qwest, BellSouth and SBC, clearly shows that there has been enormous growth in competitive local exchange facilities in the past three years. Proponents of expansive unbundling contend in their comments that unbundling should be preserved even where competitive entrants are providing their own facilities, are obtaining them from non-ILEC sources, or are competing using competitive services obtained from the ILEC. They argue in addition that emphasis on

facilities-based competition will lead to wasteful duplication of facilities, and that competitive entry is not sufficiently widespread to warrant repeal of any unbundling requirements. These arguments amount to a plea for continued unbundling even where the empirical evidence clearly demonstrates that there is no economic impairment to competitive entry. The Commission should reject such contentions. Instead, the Commission should undertake a market-by-market inquiry that examines competition in specific services and in specific geographic areas. That inquiry will demonstrate that there is in most instances no impairment to facilities-based competitive entry into local exchange markets. Both the Act and sound economic policy weigh heavily in favor of eliminating unbundling in such markets.

- A. There is No Economic Basis For Unbundling Once Entry Without UNEs has Proven Possible
2. Some parties argue that unbundling should continue to be available even where facilities-based entry is occurring (*see., e.g.,* AT&T Comments at 254). This argument eliminates any economic meaning from “impairment” and would lead to distortions of competitive incentives. As an economic matter, impairment must at the very least mean that CLECs suffer some disadvantages relative to the ILEC that are sufficiently great that they could tip to the negative a rational CLEC’s decision about whether or not to enter a local exchange market. Impairment must consist of more than the usual challenge of playing catch-up that any new entrant into a mature industry faces.

3. Importantly, the case for impairment is not made by a showing that CLECs merely face some costs that are higher than the ILEC's corresponding costs. As the U.S. Court of Appeals recently held in *USTA v. FCC*, No. 00-1012 (D.C. Cir. 5/24/02), impairment must mean something more than the cost disadvantages that new entrants usually suffer versus incumbents in any industry. From an economic standpoint, new networks will always face some initial expenses that incumbents do not at that same time have to incur, or may initially not share the same economies of scale or scope. Incumbents will already have equipment in place that a new entrant will have to purchase, and may have some economies that entrants do not initially match. Yet economists do not consider such entry costs to constitute a general "impairment" to entry. Initial cost disparities often are discrete and do not persist once entry has occurred. They may also be offset by advantages new entrants may have over incumbents. The firm investing later might get the advantage of more technologically advanced equipment which may erode the effect of any short-term cost difference between entrants and incumbents, and may benefit from other economies such as lower labor costs, the ability to serve larger areas, or to market selectively to the most lucrative segments of the market. Once CLECs have actually installed their own facilities, or once third parties have made such facilities available to CLECs, there is no basis for presuming that any incumbent's cost advantage will persist on a forward-looking basis.

4. Similarly, UNEs should not be required merely on the grounds that entry into a high-fixed-cost industry is risky for a new competitor. In many industries with high entry costs, competitors build facilities and prepare to compete with established firms well before they have any assurance of attracting a single customer. DBS providers did not sell unbundled cable service to develop brand name and a customer base before launching their satellites and building base stations. PCS providers did not rebrand conventional cellular service before spending hundreds of millions of dollars to set up their networks. Airlines like JetBlue, Southwest, and Alaska all made substantial capital outlays in advance of selling a single ticket. The point is that there is no empirical or theoretical basis for the argument that a new entrant must establish market share in advance of building facilities in order to have incentive to make the investments necessary to enter a market. Just because CLECs would *prefer* to build market share in advance of investing in facilities does not mean that absent such a risk-reducing option they would not invest in the capital necessary to compete against the ILECs. In any case, CLECs have other ways of building market share, such as resale or use of tariffed ILEC services, that do not entail all of the potential costs of an unbundling regime.

5. As an economic matter, the CLECs' plea for unbundling to coexist with facilities-based entry would, if granted, distort competitive incentives of both the facilities-based CLECs already in the market and of potential entrants. As I discussed in my initial declaration in these proceedings (at paragraphs 20-25), there are several

reasons that a CLEC might prefer using unbundled network elements to investing in its own facilities even in the absence of impairment. Continued availability of UNEs in the absence of impairment is therefore likely to undermine facilities-based investment.

6. Several commenters have challenged the argument that unbundling may chill facilities-based entry on the ground that facilities-based investment has occurred even where UNEs have been available. The declaration of Professor Kahn and Dr. Tardiff, attached to Verizon's reply comments, addresses these arguments in detail.

7. The fact that facilities-based and UNE-based entry co-exist in a market does not mean that the latter does not affect the former. Indeed, the data support the contention that the availability of the UNE platform (UNE-P) has had an adverse effect on facilities-based investment. The facts on the ground show that facilities-based investment by CLECs is *lower* in states with high volumes of UNE-P than in states with low volumes of UNE-P. AT&T's argument to the contrary (AT&T Brief at 61) is based on an incomplete picture that relies on data from just a few hand-picked states, and in some cases with data regarding only AT&T's own investments, rather than those of CLECs as a whole. As explained in detail in the accompanying UNE-P and Investment Report filed by Verizon, Qwest, Bellsouth, and SBC, AT&T's arguments disintegrate once all available data are considered.

The facts refute AT&T's claims that UNE availability promotes facilities-based entry.

8. Nor should the Commission credit claims by some CLECs that UNEs should be preserved despite facilities-based entry because there is nonetheless impairment for new firms still trying to enter given local exchange markets. As competitors enter on a facilities basis, it is natural that subsequent firms will find entry more difficult. With every new competitor chasing the same customers, the pursuit of those customers becomes less economically attractive to other potential entrants. To argue that UNEs are necessary to allow continued entry even after facilities-based entry has occurred is essentially to ask the FCC for help overcoming impairment that is not due to ILEC incumbency but rather to the increasingly competitive environment of some local markets. Yet to treat the challenges posed by competition as "impairment" is to undermine the very objectives of the Act.

9. Indeed, as more competitive facilities enter the market, unbundling becomes less about impairment to entry against an established incumbent and more about helping successive entrants into an increasingly competitive and therefore challenging environment. Yet such a policy makes no sense because it: (1) punishes earlier entrants into the market, (2) fails to recognize that high fixed cost/low marginal cost industries can only likely absorb a limited number of firms, and (3) ultimately confuses genuine impairment with the lack of an attractive business case. Each of these points warrants some elaboration.

10. First, continued unbundling after facilities-based competition has emerged can punish early entrants by subjecting them to competition from rivals that do not bear the full, risk-adjusted costs of competitive entry and which therefore can artificially undercut the early entrants' prices. The only way this harm can be avoided is if regulated UNE prices are no lower than the level that precisely covers risk-adjusted UNE costs. As discussed in my direct testimony in this proceeding, such accuracy is most improbable as a practical matter. Moreover, any attempt to resolve the potential inefficiencies of unbundling through pricing is particularly unwarranted where market participants have already demonstrated that unbundling itself is not necessary for entry. If firms have found it economically rational to enter a market with their own facilities, unbundling will only foster more entry if regulators make it inefficiently cheaper than—and harmful to—the facilities-based entry that some firms have already shown to be efficient.
11. Second, it is also important for the Commission to take into account the economics of entry into an industry that has high fixed costs and low marginal costs of production. There will not be limitless entry into such markets. It is natural that entry will become more difficult for new firms the more firms have already entered a given local exchange market. To retain unbundling obligations just so that those newer entrants can still provide service would not, however, be sound competition policy. Such continued unbundling would not be based on

impairment to competition, but on “impairment” to particular competitors. Where competition exists, policies that favor particular firms, or classes of firms, which are unable otherwise to compete are likely to create inefficient entry. For that reason antitrust law has long recognized that antitrust injury must be premised on harm to competition, not to particular, would-be competitors.

12. Third, and related to the above point, impairment should not be confused with absence of an economic business case. It may be that some markets, either because the elasticity of demand for the good or service at issue is high enough to keep prices in check, because of existing competition, or because of regulatory factors (such as retail rates set at artificially low levels), provide little incentive for competitive entry. Indeed, the firm(s) that already serves that market may do so at a loss or at least with nothing above a normal profit. New entrants will likely avoid such markets, but not because the incumbents have some advantage that impairs competition that would otherwise occur and benefit consumers. Where such advantages do not exist, unbundling should not be mandated even if no competitors have entered the market. For in such cases it is the weakness of the business case, not the strength of the incumbent, which deters entry.

B. CLEC investment will produce benefits, not waste, for the local exchange market

13. Some commenters in this proceeding have argued that the Commission should not in its inquiry give due weight to evidence of facilities-based entry because such

competition may lead to wasteful duplication of local telephone plant.¹ They thus contend that unbundling should continue as a potentially more efficient alternative even where CLECs have installed their own facilities. The Commission should reject this argument.

14. In order for facilities-based competition to be a net waste, two strong conditions must hold. The parties claiming such waste can demonstrate neither one. First, it must be the case that introduction of new facilities raises the total costs of serving all consumers in the market at issue. Second, it must be true that the benefits to consumers of an additional competitor in the market do not offset the alleged increase in cost created by the new facilities. Moreover, those conditions must hold with respect to specific network elements, not just for an integrated local exchange network as a whole. Unless proponents of extensive UNE regulation can demonstrate that these conditions hold, the Commission should reject their broadside contention that extensive unbundling provides a necessary alternative to “wasteful” and inefficient facilities-based entry. No filing in this proceeding makes that showing and it is most unlikely that either condition holds for most UNEs.

15. Even if one could show that building an entire new, integrated network would be inefficient, it does not hold that building selected new *elements* of a network would be wasteful. It may be, of course, that it would not make economic sense to

¹ ALTS Comments at 18-19, 44-45; Eschelon Comments at 10-11.

build second POTS loops in some areas (although even this is questionable going forward since second “loops” are emerging now in the form of upgraded cable systems and wireless providers). But it does not follow that competitive switching or transport facilities in those same areas would be inefficient. Inefficient duplication must therefore be rigorously demonstrated on an element-by-element and market-by-market basis. Waste of resources by facilities-based competitors is an unlikely economic outcome that cannot be casually bandied about.

16. In addition to being improbable, the duplication argument undermines a fundamental premise of the Telecommunications Act, which is that the scope of natural monopoly in the local telephone network is limited and perhaps nonexistent. As the Supreme Court has explained, the 1996 Act stood as a rejection of the idea that the local exchange was a natural monopoly:

Until the 1990’s, local phone service was thought to be a natural monopoly. . . . Technological advances, however, have made competition among multiple providers of local service seem possible, and Congress recently ended the longstanding regime of state-sanctioned monopolies.²

Congress thus clearly wished CLECs to introduce competitive facilities to the extent it is economically feasible to do so and to limit the natural monopoly portions of the network, if indeed any proved to exist, as much as possible. Broadside allegations that facilities-based competition creates wastefully “duplicative” costs thus fly in the face of the Act’s premises and cannot support

² AT&T Corp. v. Iowa Utilities Board, 525 U.S. 366, 370 (1999).

continued unbundling where competitive facilities have proven economically feasible.

II. Proper Definition of Relevant Markets is Essential to a Correct Determination of Economic Impairment

17. The fact that many new entrants are building their own facilities strongly suggests that some competitors are finding cost advantages—and hence efficiency rather than waste—in building their own facilities. But that efficiency gain is not even the relevant economic point for purposes of unbundling regulation under the 1996 Act. Once competitive facilities actually exist, the relevant inquiry under the Act is what those facilities show about the ability of CLECs to enter the local exchange market without resort to ILEC networks. The evidence presented already in this proceeding strongly suggests that for switching, transport, and high-capacity loops, many competitors find it in their interest to build their own facilities and that doing so creates no impairment to their entry into the local exchange market.

18. Given the diversity of service and market characteristics in local telecommunications today, it is impossible to make a “one size fits all” determination of competitive impairment for local exchange services nationwide. The fact that new entrants may be impaired in providing service in a particular rural market, for example, says nothing about whether that same impairment exists in other, perhaps more densely populated, markets. Moreover, impairment

in providing POTS does not mean there is impairment in providing competitive broadband or special access services. It is therefore essential for the Commission to examine unbundling at the level of specific service and geographic markets and that it define those markets correctly.

19. Correct market definition will not always mean a narrowing of focus. For example, consider broadband services. The Commission has in the past considered whether unbundling is necessary to overcome competitive impairment in the provision of broadband services that compete with the ILECs' DSL offerings. The Commission has concluded that lack of access to unbundled packet switching does not generally create impairment sufficient to warrant unbundling but that lack of access to the upper frequencies of the ILECs' loops does significantly impair competitors. The market for broadband services, properly defined, contains more than just ILEC DSL services and must include intermodal competition from cable modem services and other platforms as well. An economically correct impairment analysis must take into account this competition if it is to advance consumer welfare, and if it is to promote competition rather than simply competitors.

20. For dedicated services like special access or transport, there is also little evidence that unbundling is necessary to overcome any competitive impairment. As the 2002 UNE Fact Report filed in this proceeding demonstrates, there are substantial competing facilities for the ILECs' transport, dark fiber, and high-capacity loop

plant. Competitors needing those facilities have third party suppliers and, moreover, are shown by the evidence to be able economically to build their own facilities to compete with those of the ILECs.

21. In fact, CLECs have been able to obtain special access services facilities from the ILECs themselves even without unbundling. The ILECs provide special access services on a tariffed basis and CLECs as well as IXCs have been taking advantage of those offerings. As an economic matter, if tariffed special access services constitute an effective substitute for a dedicated transport UNE—in this case meaning the CLECs are able to enter and compete using those services—then there is no economic “impairment” if dedicated transport as a UNE is unavailable.

22. With respect to switched local services, the unbundling inquiry should take account of distinctions among specific markets. The economics of competitive entry differ depending on demographic and geographic features of a market. The fact that there may not be as extensive competition in some markets as in others should not suffice to demonstrate impairment so broadly that unbundled facilities must be made in those markets where there are no meaningful barriers to facilities-based competition. It might be that some CLECs choose to target their offerings to particular kinds of customers in a market. But that selectivity should not be confused with impairment in serving other classes of customers. The

equipment CLECs use to serve high-revenue customers can just as easily be used to serve lower revenue customers that the CLEC chooses not to pursue.

23. It is particularly important in the unbundling inquiry that product markets not be defined so narrowly that the competitive analysis ignores substitute services. Just as it would be a mistake to assess unbundling of broadband-related network elements without taking cable modem service into account, it would be incorrect to examine the switched, local service market without considering the competitive impact of wireless service. Is there intermodal competition between wireless and wireline telephone service that renders unbundling of the latter unnecessary? A consumer-oriented and pro-competitive policy depends on such a searching inquiry.

24. The importance of a detailed analysis of impairment on a market-by-market, service-by-service, and element-by-element basis undermines arguments that the Commission should preserve the so-called “UNE-P” or UNE platform. If there is no economic impairment to entering a market without unbundled access to a particular element, then there is no basis for allowing a CLEC to have unbundled access to that element when it is purchased in combination with other elements. Allowing such a UNE platform would turn impairment analysis upside down, and potentially keep all UNEs under the unbundling regime so long as impairment stemmed from any one of them. The likely result will be to deter investment in facilities even where such investment is viable. This cost of preserving the UNE-

P is not offset by any benefit to consumers. The ability of CLECs to purchase ILEC services for resale under the 1996 Act essentially means that no CLEC will be impaired if it does not have access to the UNE platform. So the Act provides alternative routes for the benefits that the UNE-P is supposed to yield.

25. Finally, even in those markets where competitive entry has not occurred, it is important for the Commission to determine whether the absence of competition is due to impairment or to the lack of a compelling business case for new firms, as already discussed above.

26. A market-by-market examination that takes into account the evidence of impairment for specific services and geographic areas will lead to a more efficient unbundling regime and to local exchange markets that better serve consumers. As the evidence presented in this proceeding clearly demonstrates, CLECs face no impairment in entering many markets using many, if not all, of their own facilities. There is no sound economic reason to continue unbundling in such markets just because in some other markets the Commission finds that there is impairment without access to those same elements.

III. Changes in the Economy should not Affect the FCC's Unbundling Decisions.

27. The Commission should not use unbundling as a tool to counteract the economic cycle that has caused the recent shake-out in the telecommunications industry.

Although I do not here purport to undertake a rigorous analysis of the different causes of that shake-out, it is quite clear that firms (even large incumbents in various sectors) are facing hardship that has nothing to do with competitive impairment. Over-investment, large debt burdens, unwise business expansion, incorrect demand predictions, and technological change have all been major factors in the current industry shakeout.

28. Policies that promote continued, rapid entry for its own sake or that artificially maintain viability for failing firms are likely to have counterproductive effects in the current environment, for several reasons. First, any policy that provides a safety net or entry path for firms whose business plans are weak will ultimately exacerbate the problem of firm failures. Second, such a policy will harm those competitors that are proving to be sound and enduring through the economic cycle and that have made the strategic decisions necessary for long-term survival. Third, the Commission should not add to the ILECs' unbundling risks by making the obligation to provide UNEs at all contingent on economic cycles. Indeed, the economic downturn affects not only CLECs, but the ILECs too, so relative impairment does not necessarily change with economic downturns. But even if relative impairment does change temporarily, it makes no sense to add burdens to the ILECs during a period of economic vulnerability in order to prop up firms that have not proven viable.

29. In sum, shake-outs are a normal and inevitable event in the life of any industry. They are particularly likely where, as here, there has been the potent combination of major regulatory change, radical change in technology, and significant changes in the nature and volume of consumer demand. The Commission should not interfere with natural shake-outs that market changes bring by using unbundling to provide a safety net for firms whose business plans proved weak or who simply have not proven sufficiently efficient and competitive to survive changes in the economic cycle. Using UNE policy to preserve firms that have not proven viable will harm those competitors that are surviving the changing economic cycle in telecommunications and risks rewarding and perpetuating the inefficiency of those firms that otherwise would have and should have left the market.

DECLARATION

I declare that the statements made above are true and correct to the best of my knowledge.

Howard A. Shelanski 7/15/02
Howard A. Shelanski