
**BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, DC 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 of the
Telecommunications Act of 1996

CC Docket No. 96-98

Deployment of Wireline Services
Offering Advanced Services
Capability

CC Docket No. 98-147

Ex Parte Presentation of

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¹ Disclaimer: The institutional affiliations are for identification purposes only. The following presentation reflects the views of Dr. Gabel only and does not necessarily reflect the views of the institutions with which he is affiliated.

Review of the Section 251 Unbundling Obligations
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October 17, 2002

Three Sources of Scale Economies

- The Courts appear to say that a UNE should be provided where to do otherwise would result in unnecessarily expensive entry costs. Economies of scale can be a source of unnecessarily expensive entry costs.
- There are three important sources of economies of scale in the telecommunications industry:
 1. Network - traditional economies of scale associated with installing facilities. (e.g., putting up poles)
 2. Back-office - Time Warner estimated that its operational support system for its telecommunications operations would cost approximately \$50m.
 3. Customer acquisition - a large entrant in the United Kingdom reported that its advertising expenditures in 1997 were \$25.9m pounds, or approximately \$41.5m.

Three Sources of Economies of Scale

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- The FCC concluded in its UNE Remand Order that “many competitive LECs are likely to incur higher costs than the incumbent LECs to attract customers, because unlike the incumbent, many competitive LECs must establish a brand name and develop a reputation for service quality before they can overcome the incumbents’ long-standing relationships with their customers.” (See, Par. . 87 of the *Local Competition 3rd Report and Order.*)

Which of These Sources of Economies of Scale Cause the Telecommunications Market to Be Distinguishable From Other Markets?

- Telecommunications was traditionally perceived as a natural monopoly because of the fixed and sunk costs associated with the construction of a network.
- OSS costs are endemic to all industries. However, the billing may be more complicated in telecommunications because of the pricing variations between and within States.
- Switching costs are higher in telecommunications than in many other lines of business because of the service concerns of customers (e.g., NorthPoint Communications scenario).
- Unbundling addresses the first (network costs), but not the second and third (customer acquisition) source of economies of scale.

US Court of Appeal's Discussion of the Pricing of Residential Service

(Opinion No. 00-1012, Released May 24, 2002)

- The Court suggests that the lack of competition in some areas may be due to subsidized rural and residential rates.
 - The degree to which these rates are subsidized was not before the FCC in the UNE remand proceeding.
 - Identifying subsidies is difficult as illustrated by the FCC's USF and CALLS proceedings.
- The Court's analysis is superficial because it relies on a mere showing that business rates are higher than residential rates. This analysis fails to take into account many factors (e.g., quality of service) that account for the business/residential rate differential.
 - Because of these other factors we observe in the Boston area two facilities based CLEC providers competing for residential customers, despite the fact that the paper cited by the Court (Crandall and Hazlett) indicates that the business retail rate in Boston is almost twice the residential retail rate.

US Court of Appeal's Discussion of the Pricing of Residential Service (continued)

- Differential pricing does not imply cross-subsidies.
 - Banks and airlines regularly charge higher prices for business class services. However, this does not lead to the conclusion that all other classes of service are being subsidized.
- The Court's argument rewrites investment theory.
 - By only considering the revenue from basic exchange service, the Court effectively argues that firms do not take into account the total stream of revenues derived from a customer.
 - This also contradicts the FCC's price squeeze analysis which has always been based on the total revenue stream obtained over the network platform - not just the price of basic service.

The Court's Understanding of How Entry Decisions are Reached is Seriously Flawed

- The Court represents that entry decisions are determined purely by the price of service. However, this certainly was not the motivating force for such firms as Teleport.
 - Teleport saw an investment opportunity when it became apparent to the business community that incumbent local exchange carriers did not provide sufficient route diversity and redundant electronics. (See, TCG Annual Report: 1994, at 4-5.)
- The FCC correctly recognized that quality of service must be considered under the impair standard. Quality of service must be taken into account when considering the fate of the UNE-P.

UNE-P

- Today a small company can acquire switching at a price that is similar to what a large company pays. (See, *In the Matter of Federal-State Joint Board on Universal Service*, 10th Report and Order, FCC 99-304, November 2, 1999, Pars. 296-319.)
 - This suggests that the switching market has the potential to be competitive in many markets.
- There are impediments to the development of competition in the residential and small business market.
 - In order to prevent a disruption of existing service, CLECs must order a “hot-cut.” The NRC for a hot-cut appears to range from \$35 to \$178. (See, Department of Justice, Qwest Application to Provide 271 Service, WC Docket No. 02-148, July 23, 2002, Footnote 156.)
 - Second, the CLEC will effectively need its own DLC for transmission between wire centers. This requires the CLEC to incur the cost of the electronics and some form of collocation.

UNE-P

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- Therefore, while alternatives suppliers of switching exist in many markets, the transaction cost of the hot-cut, along with the recurring costs of transport between the wire centers, may impair entry.

Granularity of Impair Market Analysis

- There are over 26,000 ILEC wire centers; approximately 10,200 of these are identified in LERG as RBOC wire centers.
 - Assuming, incorrectly, that only RBOC wire centers can be required to provide UNEs, and further assuming that there are effectively only six UNEs that might be included in a list of UNEs (e.g., DS0 loops, high-capacity loops, switching, transport, packet switching, signaling networks and data bases), a market analysis would have to be conducted for $10,200 * 6 = 61,200$ items.
 - This level of analysis would be, to paraphrase the Commission’s USF Inputs Order, “administratively unmanageable...” (See, *In the Matter of Federal-State Joint Board on Universal Service*, 10th Report and Order, FCC 99-304, November 2, 1999, Par. 90.)

Granularity of Market Analysis

(Continued)

- In order to effectively administer the provision of UNEs, the FCC must continue to establish reasonable national rules for the provision of UNEs.
 - If an ILEC contends, based on local market conditions, that the elimination of a UNE will not impair a CLEC's ability to compete, the ILEC should petition the State PUC for the right to eliminate the UNE in the relevant market.
 - Such a process is consistent with what currently takes place in State proceedings when an ILEC wants to detariff access or other services due to competitive conditions.

Connecticut Statute: Public Act 99-222 Sec. 5. Section 16-247b

- In determining whether facilities-based competition exists in the relevant geographic area, the department shall consider:
 - (A) The number, size and geographic distribution of other providers of service;
 - (B) The availability of functionally equivalent services in the relevant geographic area at competitive rates, terms and conditions;
 - (C) The financial viability of each company providing functionally equivalent services in the relevant geographic market;
 - (D) The existence of barriers to entry into, or exit from, the relevant geographic market;
 - (E) Other indicators of market power that the department deems relevant, which may include, but not be limited to, market penetration and the extent to which the applicant can sustain the price for the service above the cost to the company of providing the service in the relevant geographic area;
 - (F) The extent to which other telecommunications companies must rely upon the noncompetitive services of the applicant to provide their telecommunications services and carrier access rates charged by the applicant;
 - (G) Other factors that may affect competition; and
 - (H) Other factors that may affect the public interest.

Process Issues

- State PUCs typically have a good understanding of who the players are in their states and, in general, which entrants have deployed facilities.
- However, State PUCs know less about the specific areas served by the CLECs.
 - For example, a State Commission may know that a CLEC serves a city, but it is unlikely to know the percentage of customers that are in the footprint of the entrant's network.
 - The footprint of a CLEC can be ascertained through the discovery process. But a CLEC will be no more willing to hand off its network diagrams than the ILECs.
 - The ILECs have not provided complete network diagrams to the CLECs in the past because these diagrams are commercially sensitive.

Process Issues

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- Therefore, there may be a need for an independent party to create maps that identify the degree to which competitive facilities are available.
- The PUCs ability to independently address these type of questions vary greatly.
- The CLECs have limited resources for participating in State proceedings.
 - There has been a noticeable drop off in CLEC participation in State proceedings since 1997.

Process Issues

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- The FCC should provide guidance on what products should be considered to be in the same market.
 - For example, suppose that a CLEC has deployed fiber and it is used exclusively for high-speed transport. Does the availability of the fiber imply that a competitive facility is also available for DSO loops?
 - Cable companies reluctance to use their networks to provide business services suggest that it is not easy to use an existing network to provide a different type of service. This can also be seen in the decision of the DLECs to focus on providing data services, while other CLECs business plans appear to be centered on the provision of voice services.

Role of the States

- Just as the States should be empowered to make a finding based on local market conditions that a UNE no longer needs to be provided, it logically follows that the States should be allowed to add or modify the national UNE list to reflect local market conditions.
- Requiring the States to make this determination is also consistent with the FCC's objective of working closely with the State PUCs.
- Virginia SCC passed on an arbitration request submitted by Cavalier Telephone because the Virginia Commission refused to waive its sovereign immunity under the U.S. Constitution's Eleventh Amendment.
- Other States have not hesitated to resolve arbitration disputes.

Presence of Competition v. Ability to Gain Access

- The Court concluded that the FCC's line sharing order was flawed because it failed to give sufficient weight to the presence of competitors.
 - The Court criticized the FCC for not giving sufficient weight to Justice Breyer's concurring opinion in *Iowa Utilities Board*. Breyer speculated that the provision of UNEs may impede the innovation process.
 - Breyer's hypothesis merits consideration but it suffers from the shortcoming the Appeal Court lodged at the FCC's 3rd report and order—he cites no empirical data to support the hypothesis.

Presence of Competition v. Ability to Gain Access

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- Developments in New Zealand offer an interesting comparison to the US model.
- Instead of sector specific regulation, the regulatory regime for telecommunications in New Zealand relied primarily upon competition law to prevent anti-competitive behaviour.
 - New Zealand's courts decided that interconnection prices should be based on the efficient component pricing rule (ECPR). ECPR interconnection prices included the lost profit opportunities that resulted from interconnection.
 - However, the government of New Zealand recently announced that henceforth interconnection prices would no longer reflect lost profit opportunities. The change in government policy appears to be the result of the recognition that when an incumbent's profits are protected through high interconnection prices, the introduction of innovative services is delayed.

Presence of Competition v. Ability to Gain Access

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- A facility based provider, like a cable company, does provide an alternative form of access for some traffic.
 - The networks generally have not been used to serve the business market.
 - Furthermore, the pricing of access on the cable networks is much different than on a telephone network. According to Business Week, 65% of the retail broadband Internet service price is kept by the transmission provider. (See, Peter Elstrom, “Excite@Home: A Saga of Tears, Greed, and Ego”, December 17, 2001, Pages 94-99.)
- Verizon, on the other hand, has proposed in state proceedings a zero price for line sharing. SBC and Qwest have proposed higher prices, but not in the range of cable companies’ access fees.
- Hence, it is highly unlikely that the presence of one alternative facilities based provider is sufficient to produce an outcome consistent with one of the goals of the Act, securing lower retail prices.

Presence of Competition v. Ability to Gain Access

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- Indeed, one of the primary lessons for the period of duopoly in the wireless industry, both in the United States and elsewhere, is that we need more than two horses in order to have a horse race.
- On the other hand, rivalry between two suppliers at the start of the twentieth century did result in healthy competition in the U.S. telephone market.
- The history from 1900 is distinguishable from today's interactions between cable and telephony in that 100 years ago the entrant had no existing product line to protect.

Presence of Competition v. Ability to Gain Access

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- There is a trade-off in establishing unambiguous rules regarding when a network element should be removed from the UNE list.
 - On the one hand, it reduces the level of uncertainty.
 - On the other hand, it creates an incentive scheme that distorts entry decisions.
- In the United Kingdom, Oftel said that if a rival of BT achieved 25 percent or more of a specific market, such as international calls, the entrant would have to pay the same implicit access deficit charge on the traffic that was built into BT's tariffs.
 - In setting these market share limits, Oftel was mindful that the FCC had also provided discounts to new interexchange suppliers in the 1970s and 1980s, but was having trouble eliminating the price breaks. Oftel wanted the price discount to have a well-defined terminal point because by establishing all rules at the outset, it would be easier for the firms to engage in long-range planning.
 - The 25% rule discouraged entrants from gaining a share of the market large enough to trigger less favorable regulatory treatment.

How Can the FCC Help the States Set Reasonable UNE Prices? Benchmarking

- For decades regulators and academics have lamented about the asymmetric distribution of information.
 - The regulated firm has better access to cost information. Thus, it is difficult for regulators to judge the reasonableness of rates.
- The break-up of AT&T into seven RBOCs addressed this problem by creating benchmarks that could be used to evaluate the performance of the ILECs.
- The FCC provided a tremendous amount of useful information to the States in its Physical Collocation Order, FCC 97-208, when it compared the proposed ILEC charges. In that order, the Commission established a range of reasonable prices.

Benchmarking

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- As part of the 271 process, the FCC has used benchmarking to evaluate the reasonableness of recurring charges.
 - However, the FCC is unable to use a similarly transparent benchmarking methodology for non-recurring charges (NRCs) because its high-cost model only produces estimates of the recurring costs of the network.
- It is difficult for States to benchmark NRCs between jurisdictions because the ILECs use different product definitions.
 - Even within a holding company, product definitions can vary.
- The FCC should consider establishing national terms and conditions in order to aid the benchmarking of NRCs.

UNEs and Pricing

- Currently there are multiple UNEs offered for similar functionalities.
 - For example, transport can be obtained on a per minute or a capacity basis.
- The Commission should consider reducing the reliance on per minute rates.
 - Capacity charges best reflect how network costs are incurred.

Which Networks Are in the Same Market as Wireline Telecommunications?

- Cable telephony is a substitute for some customers.
 - The cable footprint may not overlap the telephone footprint. What share of a wire centers customers must overlap in order for the loop to be considered to be exempt from unbundling?
 - Some cable companies market second, but not primary lines.
- Wireless is a substitute for only some wireline phones.
 - Due to spectrum limitations, and current quality of service problems, wireless service is at best an imperfect substitute for a significant share of the wireline market.